REAUTHORIZING THE COMMODITY FUTURES TRADING COMMISSION

HEARINGS

BEFORE THE

SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY, AND CREDIT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

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Tuesday, April 14, 2015

WITNESSES

REAUTHORIZING THE COMMODITY FUTURES TRADING COMMISSION
(END-USER VIEWS)

TUESDAY, MARCH 24, 2015

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY, AND CREDIT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 1:04 p.m., in Room 1300 of the Longworth House Office Building, Hon. Austin Scott of Georgia [Chairman of the Subcommittee] presiding.

Members present: Representatives Austin Scott of Georgia, Neugebauer, LaMalfa, Davis, Emmer, Conaway (*ex officio*), David Scott of Georgia, Vela, and Peterson (*ex officio*).

Staff present: Caleb Crosswhite, Carly Reedholm, Haley Graves, Jackie Barber, Paul Balzano, Ted Monoson, Kevin Webb, John Konya, Matthew MacKenzie, and Nicole Scott

OPENING STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

The CHAIRMAN. Good afternoon. This hearing of the Subcommittee on Commodity Exchanges, Energy, and Credit regarding the reauthorization of the CFTC as it relates to end-users, will come to order.

And before we get started, I would like to just make a brief comment that we have votes coming somewhere around 1:30. If the vote is called, we will break long enough to have that and come back for questions after that.

Good afternoon. I would like to welcome you to the inaugural hearing of the Commodity Exchanges, Energy, and Credit Subcommittee of the House Agriculture Committee. I am honored that Chairman Conaway has asked me to serve the Committee this Congress by chairing our newest Subcommittee. When Mr. Conaway asked me to step into this role, he said that he wanted to ensure that the Committee never lost sight of the importance of derivatives markets not only to our traditional agricultural firms, but also to the wider economy.

Today's hearing will examine the reauthorization of the CFTC and the challenges end-users are facing as they use these markets to manage the risks of doing business in a global marketplace.

We are fortunate to be joined today by a panel of distinguished witnesses, each of whom has a unique perspective of the challenges

facing the end-users of derivatives. We look forward to hearing their thoughts on what issues the Committee should be considering during the reauthorization process.

Last week, Chairman Conaway laid out three principles for guiding the Committee's work: derivatives markets exist to meet the needs of hedgers; regulatory requirements should be both minimized and justified; and regulations should provide clarity and certainty. These principles, along with the goal to balance access with integrity, will frame our discussion today as we hear from our witnesses.

Over the past two Congresses, this Committee has heard from dozens of witnesses who have shared with us the difficulties that they have had understanding and complying with the flurry of rulemakings issued because of the Dodd-Frank Act. As I have listened to them, two things have become clear. First, no witness has called for a repeal of Title VII. In fact, most witnesses have supported the goals of Title VII. But my second point is, the process of planning, drafting, and enacting the rules could be at best called troubling. Today's task is to look back at the process of the past 5 years and to examine the places where this Committee can take action. We won't be repealing Dodd-Frank and we won't be working to weaken its market-wide protections of Title VII, but, we will be looking to see where our actions can clarify Congressional intent, minimize regulatory burdens, and most importantly, preserve the ability for these necessary risk management markets to serve the American farmers, ranchers, and businesses.

I want to thank the witnesses for appearing before us today. I know many of you traveled to be here and worked hard to prepare your remarks over the past week. I appreciate your time and efforts.

[The prepared statement of Mr. Austin Scott of Georgia follows:]

PREPARED STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

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With that, I'll turn to our Ranking Member and fellow Georgia Representative, Mr. Scott.

The CHAIRMAN. And with that, I will turn to our Ranking Member and my fellow Georgian, Representative David Scott.

OPENING STATEMENT OF HON. DAVID SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Mr. DAVID SCOTT of Georgia. Thank you, Chairman Scott. I really appreciate that. As the Democratic Ranking Member, I am looking forward to working with you and the Committee as we continue our critical mission to reauthorize the Commodity Exchange Act. Mr. Chairman, I am pleased that, as you know in the last Congress, we put together a very good bipartisan package, H.R. 4413, the Customer Protection End User Relief Act, which was good commonsense legislation that was passed in this Committee by a voice vote. It was passed on the floor of the United States House of Representatives, but unfortunately, was not voted on in last year's Senate.

So this year we need new legislation; new legislation which mirrors H.R. 4413. And a central component of H.R. 4413 was its ability to provide much-needed clarity and relief to end-users, which are our agriculture and energy producers who actually use the derivatives market to hedge against risk, and they did not cause the financial collapse. Most specifically, we need legislation that will do the following: allow end-users who are legitimate commercial market participants to avoid being inadvertently classified as financial entities because of their commercial activities. Additionally, we need language that provides alternative recordkeeping requirements to grain elevators, farmers, agriculture counterparties, and commercial market participants, instead of these entities having to meet the same recordkeeping rules as swap dealers. Furthermore, we must allow for a delay in real-time swap reporting for non-financial end-users whose swap activity can be identifiable in thinly-traded markets in order to prevent them from being competitively disadvantaged by financial players. And finally, we must require a vote by the CFTC before the swap dealer *de minimis* level automatically changes from the current level of $8 billion, which was established by the CFTC in regulations.

In conclusion, Mr. Chairman, let me emphasize Congress never intended for the end-users to be regulated in the same manner as financial entities, and I hope that we can continue our bipartisan

work in this Committee to yet again produce commonsense, bipartisan legislation that will do exactly that.

Thank you, and I yield back the balance of my time.

The CHAIRMAN. Thank you, Congressman Scott.

Mr. Conaway?

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

Mr. CONAWAY. Thank you, Mr. Chairman. I just want to, on this inaugural hearing for the—you and David's Subcommittee, just express my confidence in both of you. I have worked with David as the Ranking Member. He and I shared this responsibility for 4 years, and I have great confidence as to him. And, Austin, based on your professional background, I know you bring a wealth of talent to the table to make this happen. And you are motivated with the birth of a new daughter, Carmen Gabriella Scott, that——

The CHAIRMAN. Absolutely.

Mr. CONAWAY.—on the ground, I guess, last week. And mother and daughter are doing fine?

The CHAIRMAN. They are doing very well. Thank you.

Mr. CONAWAY. Great.

The CHAIRMAN. Thank you very much.

Mr. CONAWAY. So I thank the panel for being here today. We have some important things to do.

I too, like David, intend to get a bipartisan bill out with respect to the reauthorization. We did it last time, and have no intentions to do anything but have the bill to come out that would be bipartisan. Your hearings this week, Austin, will be an important part of our reconsideration of the legislation that was passed, and I am looking forward to the Scott cousins making this thing work. I look forward to, and have great confidence in both of you, being from Georgia.

So with that, I yield back. Thank you.

[The prepared statement of Mr. Conaway follows:]

PREPARED STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

Chairman Austin Scott has been an important voice of common sense on our Committee for the past 4 years and I am grateful that he has agreed to chair this Subcommittee. With his previous experience in the financial services industry I know he will be an asset to this Committee during reauthorization and during our oversight hearings in the coming year.

I am equally pleased that David Scott is back to serve as our lead Democrat on the Subcommittee. He has a deep knowledge of these issues and I know firsthand that he makes a great partner on these financial services issues.

One hundred and fifty years ago, the Chicago Mercantile Exchange introduced the first exchange traded futures contract.

At the time, these new financial instruments revolutionized the business of farming. Today, derivatives have expanded into every financial market and have revolutionized modern business, as well. Yet, since the financial collapse in 2008, some have questioned the value of these financial instruments which they have derided as overly complex and being too inherently risky to be used safely. I respectfully disagree.

This Committee has spent considerable time hearing from end-users, market infrastructure managers, CFTC Commissioners, and others. Time and time again, we have heard testimony about the importance of these financial tools and the tremendous value they have to those who use them. As we've heard from many witnesses,

derivatives allow businesses to reduce the risks they cannot control, so they can focus on serving their customers.

Ensuring that our nation's derivatives markets work for those who have risks to hedge is no small task.

But, I believe that the Chairman and the Ranking Member are well suited to lead the Committee's work in this area. The Agriculture Committee is unique in Congress for its bipartisan focus on outcomes over partisanship and process over politics. As we dig into CFTC reauthorization, I know that they will continue to uphold those traditions. I look forward to seeing what they can accomplish together.

The CHAIRMAN. Thank you, Mr. Chairman.

The chair would request that other Members submit their opening statements for the record so the witnesses may begin their testimony, and ensure that there is ample time for questions.

The chair would like to remind Members that they will be recognized for questioning in order of seniority for Members who were present at the start of the hearing, after that, Members will be recognized in the order of their arrival. I appreciate Member's understanding of this. Witnesses are reminded to limit their oral presentation to 5 minutes. All of your written statements will be included for the record.

Our witnesses for panel one, I would like to welcome you to the Agriculture Committee in Washington. Mr. Douglas Christie is President of Cargill Cotton, Cordova, Tennessee, and he is here on behalf of the Commodity Markets Council. Mr. Lael E. Campbell, Director of Regulatory and Government Affairs, Constellation, an Exelon Company, Washington, D.C., on behalf of the Edison Electric Institute. Ms. Lisa Cavallari, Director of Fixed Income Derivatives, Russell Investments, Seattle, Washington, on behalf of the American Benefits Council. Mr. Mark Maurer, Chief Executive Officer, INTL FCStone Markets, LLC, Chicago, Illinois. And Mr. Howard Peterson, President and Owner of Peterson Oil, Worcester, Massachusetts, on behalf of the New England Fuel Institute.

Mr. Christie, please begin when you are ready.

STATEMENT OF DOUGLAS CHRISTIE, PRESIDENT, CARGILL COTTON, CORDOVA, TN; ON BEHALF OF COMMODITY MARKETS COUNCIL

Mr. CHRISTIE. Thank you, Chairman Scott, Ranking Member Scott, for the opportunity to testify today on behalf of the Commodity Markets Council.

The CMC appreciates the opportunity to present our views on the reauthorization of the Commodity Futures Trading Commission. As you consider reauthorization, we would like to point out that the CFTC's multiyear effort to implement new swap regulatory rules has morphed into an effort to rewrite longstanding futures market regulations that Congress, via Dodd-Frank, never contemplated. These regulations are being proposed without consideration of the real impact on commodity producers or consumers. The additional regulatory impact that these actions would force upon end-users and commercial participants will ultimately be passed on as the effects work their way through the supply chain.

These actions will also impact market liquidity, which will further raise the cost of risk management, and ultimately reduce the pricing efficiency across the supply chain of finished agricultural and energy goods. These actions will result in a higher cost for risk

management, and more imperfect risk management. Orderly and established risk management practices that commercial end-users have used in the past could now be curtailed or require exemptions. This would result in more volatility, less price discovery, and more uncertainty for producers and consumers. This outcome was not intended when swap reform was initially contemplated.

Let me illustrate. The current proposed position limits rule intends to curtail excessive speculation by placing limits on the size of positions that any entity can accumulate across 28 different commodities. As has been the case for decades for commercial entities that manage risk, such as flourmills, refineries, grain elevators or exporters, or cotton shippers, the rule allows an exemption to these limits if the commercial firm has a *bona fide* reason for doing so. Unfortunately, the CFTC's proposed rule narrows the definition of *bona fide hedges* to such a degree that established risk management practices may now be excluded from the definition. The CMC and many industry groups from agricultural to energy companies have provided many detailed examples to the CFTC in public filings, and at many of the public forums the CFTC has held to discuss the position limits rule.

These examples are too numerous to recount in detail in this oral testimony. They include, but are not limited to, merchandising, anticipatory and processing hedges, irrevocable bids and offers, as well as cross hedges, gross and net hedging. These give market participants the ability to hedge not only price risk, but risk associated with time, location and delivery, or product, quality, form, specifications, or individual components of a commodity. The CFTC should limit excessive speculation by focusing the rule on the actions of excessive speculators, not by limiting the ability of commercial end-users to engage in commercially and economically-appropriate risk mitigating, *bona fide* transactions for which these markets are intended.

Congress can help by urging the CFTC to adopt a final rule that reflects the needs of end-users, and by further clarifying the definition of *bona fide hedge.*

Amendments to regulation 1.35 have created an unpredictable and onerous burden for firms in the cash business. An effort to bring swaps under a regulation that covered previously existing rules on floor traders has resulted in firms that engage in cash transactions having to keep more information about their conversations, if the conversation could lead to a derivatives transaction. Identifying which of often multiple conversation or texts or e-mails that ultimately lead to a derivatives transaction is hard to discern. Thus, the rule will force members to spend significant amounts of time and resources in a commercially impractical attempt to capture all required records, limiting the ability of commercial firms to utilize modern and efficient means of communication.

The CFTC has recognized the difficulty and attempted to modify the rule. Despite the CFTC's efforts, the uncertainty continues. CMC members believe the proposed changes do not go far enough in providing relief. At an extreme, some may consider withdrawing from membership in DCMs and SEFs, which would reduce transparency in the marketplace, and lead to legal and regulatory uncertainty for end-users and customers.

The CMC has additional priorities that are included in my written testimony. These include the importance of updating deliverable supply estimates, ensuring trade options are not subject to position limits, position aggregation, and swap dealer *de minimis* levels.

I appreciate your consideration of all the views in the CMC oral and written testimony, and I look forward to your questions.

[The prepared statement of Mr. Christie follows:]

PREPARED STATEMENT OF DOUGLAS CHRISTIE, PRESIDENT, CARGILL COTTON, CORDOVA, TN; ON BEHALF OF COMMODITY MARKETS COUNCIL

Chairman Scott, Ranking Member Scott, and Members of the Subcommittee: thank you for holding this hearing to review the reauthorization of the Commodity Futures Trading Commission ("CFTC" or "Commission"). My name is Doug Christie, President of Cargill Cotton in Memphis, Tennessee. I am testifying today on behalf of the Commodity Markets Council ("CMC").

CMC is a trade association that brings together exchanges and their industry counterparts. Our members include commercial end-users that utilize the futures and swaps markets for agriculture, energy, metal and soft commodities. Our industry member firms include regular users and members of such designated contract markets (each, a "DCM") as the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures U.S., Minneapolis Grain Exchange and the New York Mercantile Exchange. They also include users of swap execution facilities (each, a "SEF"). The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCMs, SEFs or over-the-counter ("OTC") markets. As a result, CMC is well positioned to provide consensus views of commercial end-users of derivatives with respect to CFTC reauthorization.

Cargill provides food, agriculture, financial and industrial products and services to the world. We help people thrive by applying our insights and 150 years of experience. We have 143,000 employees in 67 countries who are committed to feeding the world in a responsible way, reducing environmental impact and improving the communities where we live and work.

As Congress seeks to once again reauthorize the CFTC, we would like to emphasize several points starting with this: the CFTC's multi-year effort to implement new swap regulatory rules has now morphed into an effort to rewrite many long-standing futures market regulations that Congress, via Dodd-Frank, never contemplated. These regulations are being proposed without consideration of the real costs on commodity producers or consumers. The additional regulatory costs that the CFTC would force upon end-users and commercial participants will ultimately be passed on to producers and consumers as the costs work their way through the supply chain. There will also be an impact on market liquidity, which will further raise the costs of risk management and ultimately the cost of finished agricultural and energy goods.

CMC would like to commend the House Agriculture Committee for the CFTC reauthorization bill that was passed by this Committee and by the House of Representatives in a bipartisan fashion during the last session of Congress. CMC believes that this Committee's straight-forward approach remains the best way to address several issues end-users still face.

Since the passage of Dodd-Frank, CMC has provided a great deal of information to the CFTC in an effort to help regulators understand how our members use derivatives markets to reduce our operational risks. We have been very appreciative of Chairman Massad's consistent and appropriate emphasis on end-user issues and we have been quite pleased with the Commission's efforts to reconstitute several advisory committees which had not met in several years. The uptick in the number of public Roundtable discussions on a variety of important topics has been greatly appreciated by CMC members. With three still relatively new Commissioners, we have appreciated the Commission's willingness to listen. We appreciate the Chairman's interest in considering end-user concerns and the steps he and the Commission have taken to positively address rules such as the residual interest rule-making. CMC believes there are additional issues that warrant Congress' attention in the context of CFTC reauthorization.

End-User Concerns

CMC recognized the need for and supported reform in the over-the-counter (OTC) swaps market and believes that Dodd-Frank provided a foundation for an effective overhaul of this important risk-management market. However, there are various issues that have arisen as part of the implementation process which we believe the Committee should revisit going forward.

1. Rule 1.35

CMC recognizes the Commission's actions to amend CFTC Regulation 1.35 ("rule 1.35") and applauds its efforts. However, CMC members still believe that the costs and burdens associated with rule 1.35 as currently written vastly outweigh any benefits. CMC members remain concerned about the scope of rule 1.35's requirement to retain written communications made via "digital or electronic media" that "lead to the execution of transactions in a commodity interest and related cash or forward transactions" ("pre-trade communications"). Although unregistered members of a DCM or SEF are now exempted from the requirement to retain text messages, unregistered and registered CMC members are still troubled by the requirement to retain written and electronic records of pre-trade communications.

CMC members believe the proposed changes do not go far enough in providing relief and that the rule will force members to either withdraw from or forego membership in DCMs and SEFs, or, out of an abundance of caution, spend significant amounts of time and resources in a commercially impracticable attempt to capture all required records. Further, CMC members would like additional clarification regarding what constitutes a "text message" under the proposed amendments. CMC believes that the Commission should encourage membership in DCMs and SEFs in order to further promote transparency in the marketplace and to reduce costs for consumers of commodities. If further relief and clarification is not provided, rule 1.35 will discourage membership in DCMs and SEFs, which will in effect reduce transparency in the marketplace, limit the ability of commercial firms to utilize modern and efficient means of communication, and lead to legal and regulatory uncertainty for end-users and customers.

2. Deliverable Supply Estimates

CMC requests that the Commission make a determination about the deliverable supply estimates for each of the twenty-eight physical commodities covered by the CFTC's proposed rule that will serve as the baseline for spot month position limits. Until a proper deliverable supply baseline is established, it will be impossible to assess the appropriate long or short spot month limits that may be set for individual contract markets.

The Commission has received updated deliverable supply data from affected contract markets which CMC believes are conservative estimates. CMC urges the Commission to make an objective economic study of the relevant physical commodities that could be delivered upon expiry.

Additionally, CMC encourages the Commission to analyze physical markets in an objective fashion that is appropriate for each commodity asset class. The Commission should consider domestic storage capacity, real time production levels and historic import activity for asset classes such as oil and gas. In addition, the Commission should consider refinery capacity when considering deliverable supply for gasoline or other refined products. For grains and soft commodities, storage capacities and flows of the relevant commodity in areas that are in and tributary to the specified delivery points should provide a realistic estimate of deliverable supply.

With an objective economic study made (and an opportunity for public comments), the Commission will be in a better position to deliberate and decide, if necessary, on the appropriate Federal spot month position limit levels for each of the relevant commodity asset classes. Upon establishment of Federal limits based on updated deliverable supply estimates, the applicable designated contract markets also will be able to continue to use their discretion in setting exchange specific limits below the Federal limits as necessary and appropriate to reduce the potential threat of market manipulation or congestion.

*3. **Bona Fide** Hedging*

Commercial and end-user firms accept and manage several different types of risks in the supply chain that impact producer and consumer prices. Examples of risks are below:

- Absolute contract price risk with the counterparty (or flat price).
- Relative price risk (basis and calendar spread risk)—unfixed.
- Time, location and quality risk.

- Execution/logistics risk.
- Credit/counterparty default risk.
- Weather risk.
- Sovereign/government policy risk.

All of the above risks directly impact the commercial operations of a merchant and ultimately affect the value of the merchant's commercial enterprise (including the price the merchant pays and receives for a product). In each and every transaction, the above identified risks, including potentially others, are not the same and the relationship between them is constantly in flux. As a result the merchant must make a decision how to not only price the risk in the commercial transaction, but more importantly, how to actively hedge and manage the risks. For instance, in negotiating a forward contract with a potential counterparty, the merchant must take into consideration all of these and will make the most appropriate decision on if/when/how to utilize exchange traded futures contracts to hedge the multiple risks that are present. All of these risks affect price. In other words, the hedging of all of these risks is directly hedging price risk.

The fundamental principle is this: price risk is far more complex than just fixed-price risk, but may include volatility and similar non-linear risks associated with prices, and a transaction to hedge any of these risks in connection with a commercial business should receive *bona fide* hedging treatment. Regulators should not condition *bona fide* hedging treatment as available only when risk crystalizes by virtue of a firm holding a physical position or by entering into a contract. Commercial market practices would be severely impacted if hedging transactions were not deemed *bona fide* hedges. We ask this oversight Committee to help ensure that CFTC regulation empowers commercial and end-user firms to manage risk to the fullest extent possible.

Unfortunately, the CFTC is taking a different course by seeking to adopt a narrow view of risk. Within the CFTC's proposed position limits rule, the Commission has chosen to focus solely on the absolute price risk of a transaction with a counterparty, and is not considering the multitude of risks in the commercial operations of enterprises.

By narrowly defining *bona fide hedging,* the traditional hedger will be compromised and thus will not be able to effectively manage its risks. If this happens, risk premiums are going to rise throughout the business, which will be passed along the supply chain. Bid/offer spreads will widen and liquidity will be substantially reduced. This narrow view of hedging, if adopted, will mean that producer prices will decline and the cost to the consumer will increase.

Commercial producers, merchants and end-users have provided numerous examples to the Commission in the last three comment letter periods and have explained how detrimental it would be to constrain the market participants that are *bona fide* hedgers. A summary of several areas of concern related to hedging in the CFTC's proposed position limits rule follow below.

Anticipatory Hedging, Merchandising, & Processing

Within Title VII of Dodd-Frank and in the Commodity Exchange Act ("CEA"), Congress explicitly referred to anticipatory and merchandising hedging as *bona fide* hedging methods because they are crucial to the risk management functions of commercial and end-user firms. Anticipatory hedging allows commercial firms to mitigate commercial risk that can reasonably be ascertained to occur in the future as part of normal risk management practices. Merchandising activity enables producers to place commodities into the value or supply chains and ultimately brings those commodities to consumers with minimal price volatility.

In addition, merchandising activity promotes market convergence—a crucial aspect of the price discovery function commodity markets serve. A reduction in the efficiency of convergence increases risk, reduces liquidity, and ultimately may lead to both higher consumer prices and lower producer prices. Allowing the full scope of hedging activity promotes more efficient, effective and transparent markets—exactly the public policy goals of the Commission.

Also of concern is the issue of the anticipatory processing hedge. While the Commission's proposed rule states that such hedges are *bona fide,* the proposed rule simultaneously extinguishes the utility of the exemption by stating that anticipatory processing positions will only be recognized as *bona fide* if all legs of the processing hedge are entered into equally and contemporaneously. Hedging is based on human assessment of risk at any given time. Sometimes it is best to hedge just one leg of processing exposure. The proposed parameters around the processing hedge exemption not only fail to recognize market dynamics; worse, they put the Commission in

the position of defining risk and mandating how that risk must be hedged in the market.

Economically Appropriate Risk Management Activities

CMC would also like to express concern to this Committee with language in the CFTC's proposed position limits rule which suggests that a *bona fide* hedge only exists when the net price risk in some defined set is reduced. This is inconsistent with the manner in which a commercial firm evaluates risk—which is not limited to price risk, as mentioned above. The most appropriate way to deem a derivatives transaction as "economically appropriate" is whether a commercial firm has a risk abated by the transaction, and such risk arose in its commercial business.

Linking the ability to engage in *bona fide* hedging to a net reduction in risks across an entire enterprise, corporate family, or separately-managed lines of business is not consistent with how commercial firms commonly address risk. Moreover, individual firms identify which risks they want to accept. A transaction that may be risk reducing on one side of a business, but leave an opposite risk unhedged in another part of the business might serve legitimate business purposes. Thus, to impose a "net price risk" formula across a corporate group for purposes of *bona fide* hedging effectively replaces a commercial firm's business judgment with regulatory prescription.

Non-Enumerated Hedges

Non-enumerated *bona fide* hedges are important to commercial market participants, as they allow additional flexibility for firms to hedge risk in ways that are unforeseen. However, the ability to utilize these non-enumerated hedges is often dependent upon utilizing the hedging strategy in real time in response to fluid market conditions. Specifically, merchandisers and other intermediaries (physical, financial and risk, among others) play a vital role in helping end-users understand and ultimately reduce their risks. To the extent that these merchandisers and other intermediaries are unable to get exemptions for the hedges they require to provide these services, risk mitigation will be reduced and overall systemic risk will increase.

CMC supports allowing market participants to engage in non-enumerated hedging activity subject to a reasonable review period similar to that contained within current CFTC Regulation 1.47. In addition, we would like to emphasize that the expertise of the exchanges should continue to be drawn upon by the Commission to allow a timely review of these petitions in the most efficient manner for the Commission.

Cross-Hedging

Cross-hedging is another important hedging tool for commercial participants, and is particularly important for commodities which may be processed or transformed into products which may not be traded commodities. CMC believes that commercial firms should be granted the discretion to determine what relationships between two positions are correlated sufficiently to be considered "substantially related." The CFTC has advanced a notion of a bright-line test with respect to the regulation of cross hedges. The decision to use a cross-hedge is multi-factored, and commercial businesses have a natural profit incentive to achieve as great a correlation as possible. However, a fixed correlation is not always achievable, and sometimes risk managers are limited in their selection to what products are available. CMC members believe that a position limits regime where risk managers can freely select their cross-hedges, report them as such, and stand ready to explain them to the Commission if necessary is the proper regulatory design.

CMC has urged that the Commission not impose an arbitrary deadline upon which market participants engaged in cross hedging must exit their hedges in the spot month, near month, or in the last 5 trading days. DCMs should be permitted to set restrictions on a contract-by-contract basis, recognizing the unique characteristics of each individual commodity and contract, and the need (or lack thereof) for commercial end-users to continue to utilize cross-commodity hedges in a specific market during the spot month, near month, or in the last 5 trading days.

Gross and Net Hedging

CMC continues to request that the Commission allow end-users to utilize both "gross hedging" and "net hedging" concepts when managing risk. The Commission uses concepts of both "gross hedging" and "net hedging" in its discussion of the economically appropriate requirement, but these terms are not separately defined and the context in which they appear does not fully inform their meaning. CMC understands gross hedging to be the practice of separately hedging each of two or more related positions. Net hedging happens when that firm nets its cash purchase and sale contracts to a net long or short position and then offsets that risk by entering into short or long derivatives transactions, respectively. It is crucial that the Com-

mission affirm that each of these methods entail derivatives that would be eligible for *bona fide* hedging treatment. Additionally, when utilizing gross hedging, firms should have the flexibility to hedge either the gross long or the gross short when this is the most economically appropriate risk management position.

Wheat Equivalence Determinations

It is critical to maintain equality among the three U.S. Wheat markets: Chicago, Kansas City and Minneapolis. Currently, each market has the same spot month limit and the same single-month and all-months-combined limit. Regardless of the level at which these limits are set, parity should be maintained among these three markets. Different limits for the same type (but not necessarily variety) of commodity could dramatically impact the growth or potential for risk mitigating strategies between the contract markets. In the case of wheat, this is particularly critical given the nature of the three differing varieties. Having three varieties provides not only additional opportunities for market participants to reduce risk through spread trades, but also provides opportunity for hedging and risk management by commercial participants between markets in response to domestic or global economic factors.

4. Trade Options

CMC is urging the Commission not to categorize trade options as referenced contracts subject to position limits. These physical options, including physical forward transactions with embedded volumetric optionality, are an important tool in physical commodity markets. Trade options may be used to manage, among other things, supply chain risk, price risk or both. Subjecting these products to Federal position limits could severely harm the efficient operation of physical commodity markets and increase costs for end-users.

Trade options do not trade like physical futures and cannot simply be traded out of or unwound prior to the spot month. In the spot month, a trade option that does not qualify as a "*bona fide* hedging position" could only be offset with another physical position to bring the net position within the applicable position limit. Taking on a physical position in order to offset a trade option for position limit purposes could introduce new risks to the market participant and would undermine the entire purpose the market participant entered into a trade option in the first place. Such a result would be extremely disruptive to the physical markets.

The burden on market participants associated with speculative position limits on trade options would be substantial. Market participants would be required, for the first time, to track trade options separately from spot and forward contracts, develop systems to calculate the futures contract equivalents for these physical-delivery agreements, and, ultimately, monitor trade option positions for compliance with applicable limits.

5. Aggregation

CMC is recommending that the CFTC not pursue aggregation of positions only based upon affiliation or ownership. Instead, the Commission should require aggregation of positions where an entity controls the day-to-day trading of a portfolio of speculative positions. In the past, Commission staff highlighted the possibility of using the independent account controller safe harbor as a model for not requiring aggregation among related companies where there is ownership but not control. CMC applauds this approach and believes it may provide a useful framework for capturing the purposes of position limits while not unduly burdening otherwise separate trading activities.

Towards that end, CMC recommends the Commission adopt an exemption from the requirement that persons under common control ("excluded affiliates") aggregate their positions under certain circumstances described below.

Accounts of entities under common ownership need not be aggregated where the entities are excluded affiliates. An excluded affiliate should be defined as a separately organized legal entity:

(1) That is specifically authorized by a parent entity to control trading decisions on its own behalf, without the day-to-day direction of the parent entity or any other affiliate;

(2) Over whose trading the parent entity maintains only such minimum control as is consistent with its fiduciary responsibilities to fulfill its duty to supervise diligently the trading of the excluded affiliate or as is consistent with such other legal rights or obligations which may be incumbent upon the parent entity to fulfill (including policies and procedures to manage enterprise wide risk);

(3) That trades independently of the parent entity and of any other affiliate; and

(4) That has no knowledge of trading decisions of the parent or any other affiliate.

CMC appreciates the Committee's consideration of our views regarding the regulation of *bona fide* hedging.

6. The Swap Dealer ***De Minimis*** *Level*

As the Committee is aware, the swap dealer *de minimis* level, currently set at $8 billion, is slated to drop to $3 billion by the end of 2017. CMC members are concerned that a lower swap dealer *de minimis* level will cause companies to exit the swap business because the extra costs of swap dealer registration are not sustainable for most non-financial companies. This in turn would lead to fewer counterparties available to offer end-users risk management solutions.

A lower swap dealer *de minimis* level would lead to further consolidation of the swap business toward only a hand-full of registered swap dealers, mostly Wall Street banks. This threat is not purely hypothetical: when the CFTC initially proposed a lower dealing threshold for counterparties of municipal utilities, those utilities found that liquidity rapidly disappeared and the number of available counterparties diminished. Eventually the CFTC was forced to retreat and increase the *de minimis* level for energy swaps with municipal utilities to $8 billion.

It is likely that a lower *de minimis* level would have the same effect, not only for utilities but all companies that use swaps to manage risk. We respectfully urge the Committee to adopt a provision similar to that contained in last year's reauthorization bill which would prevent the *de minimis* level from dropping without a new rulemaking by the CFTC.

CMC believes the self-executing provision in this rule as well as the provision that was recently reversed by the CFTC involving its residual interest rule are fundamentally flawed. We applaud the Commission for their reversal on residual interest and urge this Committee to encourage the Commission to do the same regarding the swap dealer *de minimis* level.

In addition to these specific regulatory topics, CMC encourages Congress and the CFTC to continue to seek resolution to international regulatory issues. Two in particular are U.S.-EU equivalence and the Basel III Leverage Ration. With regard to the U.S.-EU equivalence issue, the lack of an equivalence determination has significant impacts to end-users that operate globally and depend on access to U.S. exchanges and clearinghouse for risk management. For example, right now U.S. futures contracts count as "OTC derivatives" under the European Market Infrastructure Regulation (EMIR) because U.S. futures exchanges have not yet been "recognized" by European regulators. This creates a disincentive for commercial end-users (Non-financial counterparties, or NFCs under the EMIR construct) that prefer not to be subject to the EMIR OTC thresholds and registration requirements as an NFC+. We are encouraged by recent progress on the broader equivalence debate and hope to see this resolved soon.

With respect to the Basel III Leverage Ratio issue, CMC members are deeply concerned that the leverage ratio will significantly increase the cost of hedging for end-users. CMC was very encouraged by Chairman Conaway and Ranking Member Peterson's letter to the Federal Reserve and also by Chairman Massad's public comments on this issue. We appreciate your engagement on this issue and hope to move the international regulatory community in the right direction.

Conclusion

Commodity derivatives markets continue to grow and prosper. They have become deeper and more liquid, thereby narrowing bid/ask spreads, and improving hedging effectiveness and price discovery. All of these developments benefit much more than just those who trade commodities. Efficient derivatives markets offer providers of food and energy the ability to reduce the multitude of risks they must manage. Consumers are the ultimate beneficiary of these efficiencies.

The swaps market reforms in Dodd-Frank were not required because of problems in physical commodity markets. Commercial end-users of agricultural and energy futures had no role in creating the financial crisis. In fact, the regulated futures market fared well throughout the financial crisis. CMC members recognize the need for the Dodd-Frank Act and support its goals, yet these regulations should be efficient and reasonable rather than overly prescriptive and complex.

We believe that as Congress considers how the CFTC is to regulate in the future, it should use the core principles on which the CFTC was founded as its guide. A balance must be maintained between regulatory zeal and consideration as to how regulatory changes could result in negative consequences to not just CMC members in the middle of the food and energy chain, but also to the producers and consumers on each side of the chain. Undue regulatory interference with the hedging mecha-

nism introduces risk that must be priced into the chain, negatively affecting both ends and everything in between. Given this, we strongly believe that the CFTC's post Dodd-Frank trend toward very prescriptive changes to futures market regulation will hinder rather than improve our economy's ability to manage commodity market risks.

While the independent regulatory agency that this Committee has oversight responsibilities over must continue to evolve in order to adequately regulate increasingly complex derivatives markets, many of these pending changes also introduce the potential for regulators to create risk and increase costs by going beyond their purview. Doing so, without consideration of the consequences, is dangerous and goes against both the "do no harm" principle of regulation as well as the CFTC's core principle regulatory heritage.

Compliance costs for end-users have skyrocketed in the past year. Today, agriculture and energy end-users are faced with thousands of pages of new CFTC rules that no one person can comprehend followed by a multitude of letters issued by the Commission to clarify rule language, extend compliance dates, or provide temporary no-action relief.

But the problem isn't only that this complexity and regulatory uncertainty adds unnecessary costs. It is also that, uncertainty, via additional regulation of the risk management tools that commodity market participants utilize, *actually creates risk* where it didn't previously exist.

CMC members mitigate risks by hedging. The fact that future regulation may determine that the risk management methods we have described here today may no longer be considered hedging is of enormous concern and is an example of where risk could be created.

When regulatory initiatives lack clarity or evolve to be at cross-purposes with the core principles on which the Commission was founded, CMC members are compelled to reach out to this Committee for help. We believe last year's CFTC reauthorization bill provided significant clarity to the marketplace and we hope to be a resource to the Committee once again as it pursues CFTC reauthorization this year.

Thank you for this opportunity to testify. We look forward to continuing to work with this Committee to strike the right balance.

I look forward to your questions.

The CHAIRMAN. Mr. Campbell.

STATEMENT OF LAEL E. CAMPBELL, DIRECTOR OF REGULATORY AND GOVERNMENT AFFAIRS, CONSTELLATION ENERGY (AN EXELON COMPANY), WASHINGTON, D.C.; ON BEHALF OF EDISON ELECTRIC INSTITUTE

Mr. CAMPBELL. Thank you, Chairman Scott, Ranking Member Scott, and Members of the Subcommittee. Thank you for the opportunity to discuss the views of end-users in reauthorizing the Commodity Futures Trading Commission.

I am Lael Campbell, Director of Regulatory Affairs, with Exelon Corporation, testifying on behalf of the Edison Electric Institute, EEI.

EEI is the association of U.S. investor-owned electric utilities whose members serve nearly 70 percent of America's industries, businesses and consumers with their electricity. EEI members are the quintessential commercial end-users.

The goal of EEI member companies is to provide their consumers with reliable electric service at affordable and stable rates, and the derivatives markets are a critical tool for insulating our customers from energy price risk. As end-users, we support the Dodd-Frank Act's primary goals of mitigating risk to the financial system, and increasing transparency in the derivatives markets, however, there are areas where Congress should consider minor adjustments to ensure that Dodd-Frank achieves its purpose, while not impeding our ability to hedge and manage risks associated with our core

business of producing and delivering physical energy to our customers.

I would like to highlight three of these concerns: the treatment of physical contracts of volumetric optionality, the *de minimis* threshold, and the definition of *bona fide hedging*. One of the key concerns for end-users is an interpretation of the definition of a *swap* that includes options for physical delivery, as well as physically settled forward transactions with imbedded optionality. These are physically settled contracts that are entered into solely between physical market participants, and serve the purpose of providing flexibility to respond to changing supply and demand circumstances such as ensuring delivery of fuel to a generation plant when that fuel is needed. Treating these everyday physically delivered transactions that are used to manage operational and physical supply risk as swaps has significantly and unnecessarily increased end-user compliance costs with no recognizable offsetting public benefit. If a transaction at inception is intended for physical settlement, the transaction should be excluded from the term *swap*.

Another important issue for end-users is the automatic drop of the *de minimis* threshold for registration with the CFTC as a swap dealer. The CFTC set this *de minimis* threshold at $8 billion, however, the *de minimis* threshold is scheduled to be reduced automatically to $3 billion at the end of 2017, without any stakeholder process. End-users are concerned that a lower swap dealer *de minimis* threshold will cause companies to cease transacting in swaps with other end-users, leading to fewer hedging counterparties available in the market, making hedging and risk management all the more difficult and costly. Notably, we have already experienced a negative impact of an unreasonably low *de minimis* threshold. When the CFTC initially proposed a lower swap dealing threshold for counterparties of municipal utilities, those utilities found that the number of available counterparties diminished significantly, essentially leaving only the large banks to transact with. This experience highlights the important role the end-user-to-end-user swap market plays in managing risk in the energy space, and shows that a lower *de minimis* level will likely result in decreased market liquidity, and in turn, increased risk, increased cost to hedgers, and ultimately increased cost to consumers.

The final issue I would like to discuss is the proposed narrowing of what constitutes a *bona fide* hedge. The dynamic and complex nature of energy markets, in particular, electricity markets, demands flexibility to those charged with managing risk in these markets. EEI is concerned that the CFTC's position limit rule unduly precludes long-established and well-accepted hedging practices. Although EEI has a number of concerns in the area of position limits, I would like to highlight the proposed limitation on the ability to engage in cross commodity hedging, for example, using a natural gas derivative to hedge electricity price risk. Under the proposed rule, the CFTC would only presume *bona fide* hedging status for a cross commodity hedge if it meets a rigid mathematical correlation. This quantitative requirement ignores the undeniable relationship between the price of electricity and the price of the fuels used to generate electricity, as well as the longstanding and accepted risk management practice of power generators and power

suppliers to use fuel-based derivatives to hedge electricity price risk. Deference must be given to long-established and widely recognized risk management practices of end-users, such as cross commodity hedging. A narrowing of the *bona fide hedging* definition that ignores these industry-accepted practices will stifle market liquidity, negatively impact price transparency, and increase hedging costs. These costs ultimately will be reflected in the prices consumers pay for energy.

In conclusion, I would like to thank the Committee for helping to ensure that EEI members continue to use derivatives to protect our companies and their consumers from energy price risk.

Thank you for the opportunity to testify, and I would be happy to answer any questions.

[The prepared statement of Mr. Campbell follows:]

PREPARED STATEMENT OF LAEL E. CAMPBELL, DIRECTOR OF REGULATORY AND GOVERNMENT AFFAIRS, CONSTELLATION ENERGY (AN EXELON COMPANY), WASHINGTON, D.C.; ON BEHALF OF EDISON ELECTRIC INSTITUTE

Introduction

Chairman Scott, Ranking Member Scott, and Members of the Subcommittee, thank you for the opportunity to discuss the views of end-users in reauthorizing the Commodity Futures Trading Commission (CFTC) through the Commodity Exchange Act Reauthorization.

I am Lael Campbell, Director of Regulatory and Government Affairs with Exelon Corporation, testifying on behalf of the Edison Electric Institute (EEI). EEI is the association of U.S. investor-owned electric utilities, international affiliates and industry associates worldwide. Our industry directly employs more than 500,000 workers, and EEI's investor-owned electric utility members serve nearly 70 percent of America's industries, businesses and consumers.

Headquartered in Chicago, Exelon conducts business in 48 states, the District of Columbia, and Canada. The company is one of the largest competitive U.S. power generators, with power plants in 19 states. Exelon owns or controls approximately 35,000 megawatts of generation capacity, is the nation's largest nuclear operator, and one of the nation's largest wind energy generators, comprising one of the nation's cleanest and lowest-cost power generation fleets. Exelon also owns three utilities, which reliably deliver electricity and natural gas to more than 7.8 million utility customers in central Maryland (Baltimore Gas & Electric Company), northern Illinois (Commonwealth Edison), and southeastern Pennsylvania (Philadelphia Electric Company or PECO). Finally, our Constellation-branded family of competitive retail businesses serves more than 2.5 million residential, public sector, and business customers with electricity, gas, energy management services and distributed generation, including more than ⅔ of the Fortune 100.

The electric power sector is a $910 billion industry and is the most capital-intensive industry in the United States. It is projected to spend approximately $90 billion a year, on average, for major transmission, distribution and smart grid upgrades; cybersecurity measures; new, cleaner generating capacity; and environmental and energy-efficiency improvements. The electric power industry represents approximately two percent of our nation's real gross domestic product.

EEI members are non-financial entities that primarily participate in the physical commodity market and rely on swaps and futures contracts to hedge and mitigate their commercial risk. The goal of our member companies is to provide their consumers with reliable electric service at affordable and stable rates, which has a direct and significant impact on literally every area of the U.S. economy. Since wholesale electricity and natural gas historically have been two of the most volatile commodity groups, our member companies place a strong emphasis on managing the price volatility inherent in these wholesale commodity markets to the benefit of their consumers. The derivatives market has proven to be an extremely effective tool in insulating our consumers from this risk and price volatility. In sum, our members are the quintessential commercial end-users of swaps.

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") provides certain exemptions for non-financial end-users, recognizing that they are not the entities posing systemic risk to the financial system. Since passage of the Dodd-Frank Act, we have been actively working with

Federal agencies, including the CFTC, as they work their way through the implementation process to ensure that the Congressional intent of protecting non-financial end-users from unnecessarily burdensome impacts of financial market reform remains intact. Even though a majority of the rules have been promulgated by these agencies, concerns still surround some of the remaining issues important to electric companies.

We support the Dodd-Frank Act's primary goals of protecting the financial system against systemic risk and increasing transparency in derivatives markets. However, there are areas where Congress should consider minor adjustments to ensure the Dodd-Frank Act achieves its purpose while not inadvertently impeding end-users' ability to hedge. Last year, through the bipartisan leadership of Congressmen Lucas, Peterson, Conaway, and Scott, and all the Members of this Committee, H.R. 4413—the Customer Protection and End User Relief Act—was passed out of the House by a bipartisan vote of 265–144. This legislation contained a number of those minor adjustments we believed could have helped to ensure that the end-user community was not inadvertently swept into regulations that were not intended to cover us.

As this Subcommittee and Congress again examine possible modifications to the Commodity Exchange Act, we hope we can build upon the successes of last year's legislation and ask that you again consider the following issues:

Volumetric Optionality

One of the key concerns for end-users is an interpretation of the definition of a "swap" that includes within that definition certain physically-delivered contracts entered into only by physical market participants. EEI members believe that regardless of whether the non-financial commodity transaction at issue is a forward contract with "embedded optionality" or a "stand-alone" commodity trade option, if the transaction at inception is intended for physical-settlement, the transaction is excluded from the term "swap" for all regulatory purposes by the Commodity Exchange Act (CEA 1a(47)(B)(ii)). The predominant feature of these contracts, as contemplated by the parties at the time the contract was entered into, is actual delivery; the embedded optionality does not undermine the overall nature of these contracts as forward contracts. As such, we respectfully urge the Committee to adopt a provision similar to that contained in last year's reauthorization bill that clarified that all sales of a non-financial commodity for deferred shipment or delivery, so long as the transaction is intended to be physically settled at the time it is entered into, is not a swap regardless of whether it contains an embedded option.

Trade options and physically delivered forward transactions with embedded optionality serve the purpose of providing the option holder flexibility to respond to changing supply and demand circumstances, such as ensuring delivery of fuel to a generation plant when fuel is needed. EEI members create a physical supply portfolio designed so that they can provide electric service to their retail consumers at low rates. Contracts for physical delivery of commodities such as electricity or natural gas are vital to the business of EEI members. Treating every-day transactions that are used to manage operational and physical supply risks as "swaps" has significantly, and unnecessarily, increased end-user regulatory and compliance costs associated with these transactions, with no recognizable offsetting public benefit.

***De Minimis* Level**

The CFTC issued a proposed rule on the swap dealer *de minimis* threshold for comment in early 2011. After review of hundreds of comments, a series of Congressional hearings and after dozens of meetings with market participants, the CFTC set this *de minimis* threshold at $8 billion. However, absent an affirmative CFTC action, the *de minimis* threshold is scheduled to be reduced automatically to $3 billion at the end of 2017.

End-users are concerned that a lower swap dealer *de minimis* threshold will cause companies to cease transacting in swaps with other end-users because the extra costs and burdens associated with registration as a swap dealer are not sustainable for most commercial energy companies. This in turn will lead to fewer hedging counterparties available in the market, making hedging and risk management all the more difficult and costly for end-users. This concern is imminent, despite the 2017 date for the drop in the threshold. Because the *de minimis* measurement is over a 1 year period, end-users will have to make these critical business decisions and adjust their activities beginning in 2016.

A lower swap dealer *de minimis* level would lead to further consolidation of the swap business to a handful of registered swap dealers, mostly large Wall Street banks whose primary business is dealing in swaps. This threat is not purely hypothetical: when the CFTC initially proposed a lower dealing threshold for counterpar-

ties of government and municipal utilities ("utility special entities"), those utility special entities found that liquidity rapidly disappeared and the number of available counterparties diminished significantly. Eventually the CFTC acknowledged the negative impact this low threshold had on the ability of utility special entities to hedge their risk with other commercial counterparties, and the CFTC increased the *de minimis* level for energy swaps with these special entities to the same $8 billion threshold that applies to all swaps. This example highlights the important role the end-user to end-user swap market plays in managing risk in the energy space. It is likely that a lower *de minimis* level would result in an impact similar to what was seen for utility special entities, but this time the impact will be felt by all commercial end-users that use swaps to manage risk, not just municipalities.

As such, EEI opposes this dramatic reduction in the *de minimis* threshold that is set to take place without any deliberate CFTC action. The CFTC should not have the authority to change the *de minimis* level without a formal rulemaking process that allows stakeholders to provide input on what the appropriate threshold should be. We respectfully urge the Committee to adopt a provision similar to that contained in last year's reauthorization bill that would prevent the *de minimis* level from dropping without a new rulemaking by the CFTC.

Requiring that a rulemaking process be in place rather than an automatic reduction does not take any discretion away from the CFTC but will help ensure that stakeholders have input into the appropriate level for the threshold. Absent these procedural changes, we are concerned a deep automatic reduction in the *de minimis* level could hinder the ability of end-users to hedge market risk while imposing unnecessary costs that eventually will be borne by consumers.

***Bona Fide* Hedging**

The dynamic and complex nature of energy markets, in particular electricity markets, demands flexibility to those charged with managing risk in these markets. EEI is concerned that the CFTC's Proposed Position Limits Rule unduly limits the hedging activities of commercial end-users by precluding long-established and well-accepted hedging practices. The question for the Commission is what constitutes excessive speculation, as some amount of speculation is needed to maintain liquidity in the markets. What constitutes excessive speculation may also depend on the market as commodity prices are inherently volatile and are dependent on a number of factors such as demand for the commodity, customer demand, weather, and mechanical outages, among others. If applied inappropriately, position limits could have the effect of limiting or constraining risk. Unreasonable and unsupported position limits stifle market liquidity, negatively impact price transparency, and increase the cost of hedging. Any increase in hedging costs ultimately results in an increase of the price our consumers pay for the energy we provide. The CFTC has not made fact-based findings on the need for position limits.

EEI is concerned that the Proposed Rule discounts the importance of long-established hedging practices that have been used by EEI members and other commercial end-users by limiting traditional practices such as hedging on a portfolio basis, anticipatory hedging, cross-commodity hedging and hedging of unfixed price risk.

Gross Hedging

The proposed position limits rule implies that an entity has to net all of its physical exposures enterprise wide in order to qualify for *bona fide* hedge status, and that the entity cannot take into account exposures on a legal entity or portfolio basis. Portfolio-based risk management is a common and long-standing commercial practice of producers, processors, merchants and commercial users of commodities and commodity byproducts. This is especially important to EEI members as energy markets are regional in nature. As a result, many utilities and independent power producers manage portfolios of risk by region. In one region, a power producer may be long physical generation, and in another region it may be short physical power (*i.e.,* it has more load or demand for power than it has generation). A power producer's long physical position in one region should not limit its ability to hedge its short physical position in another region. The regional nature of the electric power industry also means that hedging on a net basis would be unworkable, requiring costly new technology systems to be built around more rigid, commercially impractical hedging protocols that prevent dynamic risk management in response to rapidly changing market conditions. Moreover, forcing end-users to net positions between regions, or business units, that may have limited commercial relationship with each other, will increase risk, not decrease risk.

Cross-Commodity Hedging

Under the Proposed Rule, the CFTC would only presume *bona fide* hedging status for a cross-commodity hedge (*e.g.,* hedging electricity price risk with a natural gas

derivative) where there is an appropriate quantitative relationship "when the correlation, between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract is at least 0.80 for a time period of at least 36 months." This quantitative requirement ignores the relationship between the price of the fuel used to generate electricity and the price of electricity, and the long-standing and accepted risk management practice of utilities and other power generators to use natural gas Referenced Contracts and other fuel-based derivatives to hedge the price risk associated with their electricity production.

Many market participants hedge long-term electricity price exposure with natural gas derivatives contracts because there is insufficient liquidity in deferred month electricity derivatives contracts. Therefore, requiring the proposed quantitative correlation in outer months would eliminate all available tools for hedging at illiquid locations which, in turn, would result in higher risks for market participants and higher costs for consumers. Due to long-established risk manage[ment] practices using cross-commodity hedges, EEI would urge the Commission to give discretion to this widely recognized risk management practices used in the industry.

Anticipatory Hedging

There are legitimate commercial reasons for commercial end-users to engage in anticipatory hedging, and a final position limits rule should not restrict this activity. For example, an EEI member should be permitted to hedge a binding and irrevocable bid in a state-administered auction for suppliers to provide electricity to utility consumers. Taking away suppliers' ability to hedge their irrevocable bids in the period between making the bid and the auction results being approved by the state utility commission will result in the risk of a market move during this interim period being factored into the bid price, which will raise prices for consumers.

Unfixed Price Risk

EEI members are concerned that the proposed position limits rule only provides *bona fide* hedge treatment for "unfilled" anticipated fuel requirements for a generator. However, it is common in the electricity industry for a generator to "fill" its fuel requirements with an unfixed price fuel supply contract. This contract ensures the generator will have the physical fuel supply, but still leaves the generator exposed to unfixed or variable price risk. *Bona fide* hedging treatment should be provided to generators (or other commercial market participants) for transactions that hedge or "fix" their market exposure to unfixed price risk, even if their anticipated fuel requirements are "filled". The fact that such a common transaction does not receive *bona fide* hedge treatment under the Proposed Position Limits rule further supports the need for the Committee to require the CFTC to recognize commonly accepted risk management practices of end-users.

EEI members follow documented risk management procedures to ensure that hedging transactions are designed to manage the risks incurred in their commercial operations. In addition, since the hedges are based on physical commodities, the value of the hedge changes as the market moves. Many EEI members have front office commercial operations personnel, supported by middle office risk management policies and back office derivative accounting processes, who have the responsibility of managing complex and dynamic commercial operations that incur risks from volatile commodity prices. If a hedge is not effective, these controls will identify it and require a change. As such, the CFTC should be required to continue to recognize the industry's risk mitigation practices, and the Committee should not permit the CFTC to further restrict what constitutes a *bona fide* hedge.

Inter-Affiliate Transactions

Currently, the CFTC's rules and proposed rules generally treat inter-affiliate swaps like any other swap. Hence, companies must, under certain circumstances, report swaps between majority-owned affiliates and must submit such swaps to central clearing unless the end-user hedging exception applies or complex criteria for the inter-affiliate clearing exemption are met. In the absence of a more expansive clearing exemption for inter-affiliate trades, the costs of clearing likely would deter most market participants from entering into inter-affiliate transactions. For example, without an exemption, additional affiliates in a corporate family would need to become clearing members or open accounts with a Futures Commission Merchant, and all affiliates would need to develop and implement redundant risk management procedures and trade processing services.

In contrast to market-facing swap transactions, swaps between majority-owned affiliates are typically entered into for operational and administrative efficiency in managing a commercial enterprise. The CFTC has provided some relief in the form of no-action letters, but these no-action letters do not provide end-users with ade-

quate certainty. We ask that the Committee provide this certainty by permanently exempting swap transactions between majority-owned affiliates from these unnecessarily burdensome reporting and clearing obligations.

1.35

CFTC Regulation 1.35(a) imposes broad recordkeeping requirements on certain market participants, including "members" exchanges (DCMs and SEFs). EEI appreciates the Commission's proposal to reduce some of the recordkeeping burden imposed by Commission Regulation 1.35(a) on commercial end-users. However, while the Commission's intentions are well-placed, the approach in the Commission's Proposed Rule still leaves uncertainty and costs that are not necessary to impose on persons that are not registered with the Commission and who are only executing trades for their own account. For example, although unregistered members of a DCM or SEF are now exempted from the requirement to retain text messages, unregistered members must still retain written and electronic records of pre-trade communications. As a result of these unnecessary burdens, end-users may opt not to become members of a DCM or SEF, despite the policy goal of the Dodd-Frank Act to encourage more on-exchange activity. For this same reason end-users may also forgo a direct clearing membership arrangement, despite growing global concerns with rising costs of clearing that a direct clearing membership would help mitigate.

EEI respectfully requests that the Committee clearly exclude from the application of Regulation 1.35 commercial end-users that are not registered with the Commission and who are not transacting on behalf of consumers.

Financial Entities

The Dodd-Frank Act defines the term "financial entity", in part, as an entity that is "predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956." Incorporating banking concepts into a definition that also applies to commercial commodity market participants has had unintended consequences.

Unlike our members, banks and bank holding companies generally cannot take or make delivery of physical commodities. However, banks and bank holding companies can invest and trade in certain commodity derivatives. As a result, the definition of "financial in nature" includes investing and trading in futures and swaps as well as other physical transactions that are settled by instantaneous transfer of title of the physical commodity. An entity that falls under the definition of a "financial entity" is generally not entitled to the end-user exemption—an exemption that Congress included to benefit commercial commodity market participants—and can therefore be subject to many of the requirements placed upon swap dealers and major swap participants. In addition, the CFTC has used financial entity as a material term in numerous rules, no-action relief, and guidance, including, most recently, its cross-border guidance. The Dodd-Frank Act allows affiliates or subsidiaries of an end-user to rely on the end-user exception when entering into the swap on behalf of the end-user. However, swaps entered into by end-user hedging affiliates who fall under the definition of "financial entity" cannot take advantage of the end-user exemption, despite the fact that the transactions are entered into on behalf of the end-user.

Many energy companies structure their businesses so that a single legal entity within the corporate family acts as a central hedging, trading and marketing entity—allowing companies to centralize functions such as credit and risk management. However, when the banking law definitions are applied in this context, these types of central entities may be viewed as engaging in activity that is "financial in nature," even with respect to physical transactions. Hence, some energy companies may be precluded from electing the end-user clearing exception for swaps used to hedge their commercial risks and be subject to additional regulations applicable to financial entities. Importantly, two similar energy companies may be treated differently if, for example, one entity uses a central affiliate to conduct these activities and another conducts the same activity in an entity that also owns physical assets or that has subsidiaries that own physical assets. Accordingly, Congress should amend the definition of "financial entity" to ensure that commercial end-users are not inadvertently regulated as "financial entities."

Conclusion

Thank you for your leadership and ongoing interest in the issues surrounding implementation of the Dodd-Frank Act and their impact on commercial end-users. We appreciate your role in helping to ensure that electric utilities can continue to use

over-the-counter derivatives in a cost-effective manner to help protect our electricity consumers from volatile wholesale energy commodity prices.

Again, I appreciate the opportunity to testify and would be happy to answer any questions.

The CHAIRMAN. Ms. Cavallari.

STATEMENT OF LISA A. CAVALLARI, DIRECTOR OF FIXED INCOME DERIVATIVES, RUSSELL INVESTMENTS, SEATTLE, WA; ON BEHALF OF AMERICAN BENEFITS COUNCIL

Ms. CAVALLARI. Good afternoon, Chairmen Conaway and Scott, and Ranking Members Peterson and Scott. I am Lisa Cavallari, Director of Fixed Income Derivatives at Russell Investments.

Russell Investments is a global financial services firm, and provides consulting, asset management, trading implementation, and index services. We provide these services as a fiduciary for our clients, and an agent of our clients, which means that we act exclusively on their behalf. The overwhelming majority of our clients are pension plans. Russell is also a Member of the Board of Directors of, and works closely with, the American Benefits Council, whose mission, like ours, is dedicated to the advocacy of employer-sponsored benefit plans. The Council is a public policy organization representing principally Fortune 500 companies, and other organizations that assist employers of all sizes.

I am grateful for the opportunity to speak to this Subcommittee, and share my ideas and ways about which we can collectively continue the good work that Congress and the CFTC has chosen to achieve its ambitious goals set about by the G20.

First, I would like to discuss how pension plans and end-users of the swaps use particularly bilateral, cleared and futures markets, then I would like to discuss some very real-life costs that our pension plan users are facing, and some of the challenges that we have had to face these last couple of years.

Pension plans use swaps for a range of risk-reducing activities, in part because they are a cost-effective way of obtaining and eliminating specific exposures quickly. An example of risk reduction is the use of interest rate hedging by pension plans. Interest rate swaps, both cleared and uncleared, are an effective hedge against any potential volatile interest rate movements. If a plan has $5 billion in assets and $5 billion in liabilities today, everything is balanced. However, if interest rate swaps decline, this impacts the liability side of the equation, and it could create a funding shortfall. Depending upon the severity of this shortfall, under the worst circumstances, it could serve to strain the employer's balance sheet and give rise to solvency risk. Under the more likely scenario, however, is that it will require the employer to divert resources away from efforts that lead to economic expansion. This shortfall can be cost-effectively eliminated by employing interest rate swaps. Even in this low interest rate environment that we are experiencing today, interest rate swap instruments can meaningfully reduce the volatility of the funded status of a plan. This is a powerful risk mitigant that we need to ensure can continue to be assessable by plans.

I would like to discuss briefly some of the costs that our end-users are now facing in a very real-life and dramatic example. A

pension plan client of Russell's, one that is active in the futures, cleared swaps, and bilateral swaps worlds, is facing significantly-rising costs. Russell is an agent and fiduciary and investment advisor for this pension plan that trades billions of dollars. On an annualized basis, their costs were, at the end of 2014, about $25,000, again annualized, for billions of dollars and positions. The FCM, a clearing member who acts as an agent on our client's behalf, has recently raised their fee schedule to over $560,000 annually. They have cited a combination of Title VII regulations that, conspired with the Basel III capital ratios that these swap dealers need to maintain, together, these forces have conspired to increase the cost of these pension plans, and we have no doubt that that will continue.

Some of the factors that contribute to these increases in costs are ideas of netting, when it regards—in regards particularly to pension plans, and also the posting of initial margin. Though complicated in nature and multifaceted, we look forward to working with different regulators, prudential and—as well as the CFTC, to overcome these obstacles. A conservative pension plan client base is important as well as other members of this panel in terms of the constituencies for the liquidity that they provide the swaps market. This is a very important detail.

As a side note, the initial margin, which traditionally pension plans have not posted in the bilateral markets, could be imposed if proposed rules are set in place. This is, again, something that we would challenge, as the end-user of a derivative, is a very conservative pension plan.

Some of these forces have conspired to increase costs, as I used in my example. We welcome the opportunity and we have seen, certainly with Commissioner Giancarlo's white paper on SEFs, we welcome the opportunity and have worked closely with the CFTC and staff to make tweaks around the margin for the different rules that have been put in place as a result of Title VII.

Again, I am grateful for the opportunity to just outline a few of the issues which are very pertinent to the pension plan community and the end-users that I represent.

Thank you again for your time.

[The prepared statement of Ms. Cavallari follows:]

PREPARED STATEMENT OF LISA A. CAVALLARI, DIRECTOR OF FIXED INCOME DERIVATIVES, RUSSELL INVESTMENTS, SEATTLE, WA; ON BEHALF OF AMERICAN BENEFITS COUNCIL

Good afternoon Chairmen Conaway and Scott and Ranking Members Peterson and Scott. I am Lisa Cavallari, Director, Fixed Income Derivatives at Russell Investments. Russell Investments is a global financial services firm that provides consulting, asset management, trading implementation and index services. We provide these services as a fiduciary and an agent of our clients which means that we act exclusively on their behalf. The overwhelming majority of our clients are pension plans or other retirement arrangements that themselves are focused on finding ways to improve their financial security and the long-term financial security of their participants. These clients include many of the major and mid-size U.S. corporations, endowments and foundations, and public retirement systems that drive our economy. Our entire business is built around serving the needs of these clients.

Russell is also a Member of the Board of Directors of and works closely with the American Benefits Council (the "Council") whose mission, like ours, is dedicated to the advocacy of employer sponsored benefit plans. The Council is a public policy organization representing principally Fortune 500 companies and other organizations

that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans. We appreciate the Council's years of service and hard work to be an advocate for employer plans and the many thousands of employees who rely on those plans and their employers to help them reach a more secure financial future.

In order to efficiently and effectively help these clients reach their financial goals, Russell trades a variety of instruments through a number of global trading partners and venues. Those instruments include billions of dollars of exchange traded futures and cleared swaps as well as bilateral, uncleared swaps. As a practitioner who trades these instruments for our clients, I am grateful for the opportunity to speak to this Subcommittee and share my views about ways that we can collectively continue the good work of Congress and the CFTC to achieve the ambitious goals set forth by the leaders of the G20 starting in 2009. Derivatives, including both futures and swaps, are an important part of any investment advisor's toolkit and are crucial to achieving many investment goals. Fiduciaries like Russell evaluate them for their appropriateness and often recommend them to achieve client investment objectives.

My trading team is dedicated to facilitating and executing derivatives trading for our clients. It is truly a team effort. We work closely with our colleagues in the documentation, legal, compliance, risk and technology areas to achieve this. Whether it was Mies Van de Rohe or Flaubert who are each alleged to have said "God is in the details," the fact remains that those details have very real consequences. The trading desk often stands at the intersection of many of those details as it pertains to derivatives regulation.

We appreciate the role of the Dodd-Frank Act in adding greater transparency to the marketplace so that investors can make use of available products in a way that allows them to effectively meet their specific investment and risk mitigation goals. We believe the agencies—including the Commodity Futures Trading Commission ("CFTC"), which has jurisdiction over the types of swaps most important to plans, and the prudential regulators—have worked hard to provide helpful guidance and have been very open to input on the derivatives issues from the pension plan community. We recognize the diligence and enormous effort required of U.S. and other global prudential regulators to bring transparency to an over-the-counter marketplace for bilateral swaps that in terms of dollars notional outstanding is nearly 24x that of the exchange traded futures markets.[1]

As Russell and other industry participants work to ensure a transition from the rulemaking phase to implementation, we welcome continued open dialogue surrounding these historically unprecedented changes. In this regard, there are implementation issues affecting the pension plan community that could have very adverse effects on plans and on their ability to mitigate risk.

To further the dialogue, I would like share my views on the following topic areas:

- Background on the primary types of derivatives we trade.
- How, why, and the extent to which pension plans use these derivatives.
- Factors driving increasing costs and barriers to access for pension plans to use derivatives.
- Summary of specific examples of concerns and thoughts on how to address emerging challenges.

Background on the Primary Types of Derivatives We Trade

Today the primary three categories of derivatives are (i) Bilateral Swaps, (ii) Futures, and (iii) Cleared Swaps. While these products may appear complicated and it is in part due to that they are questioned, each has a valuable role in the world of investments, particularly for pension plans.

At the time of the Global Financial Crisis, there were only futures and bilateral uncleared swaps. Pension plans frequently used a combination of both. Exchange traded futures are trade standardized contracts executed and cleared with a clearing member under a Futures Commission Merchant (FCM) Agreement. Pensions frequently use futures exposure to gain access to a variety of global equity indices. Futures contracts have counterparty credit risk with the clearinghouse and the FCM. Collateral in the form of both initial margin (different for the risk profile of each product contract) and variation margin (for daily marked-to-market changes) is applicable.

Bilateral swaps, like their name suggests, are traded under specific negotiated documentation with a trading counterparty. Only the two parties involved in the

[1] Bank for International Settlements *BIS Quarterly Review Dec 2014* and *March 2015. http://www.bis.org/publ/qtrpdf/r_qs1503.pdf*. Statistical Annex: Detailed Tables 19 and 23A.

agreement may trade under it. An International Swaps and Derivatives Association (ISDA) Master Agreement is frequently used as the contract that outlines the rights of each party involved with a trade. Bilateral swap exposures, unlike futures, can be tailored to suit a specific need. One example of a trade type is a Russell 2000 total return swap, where a pension plan may want to pay a fee in order to receive the return of the Russell 2000 stock index. Whereas the future trades with quarterly expirations, in set contract amounts and sizes, the bilateral swap can be tailored to have a maturity to match exactly the need of the pension. This flexibility and customization is extremely important for pension plans who have precise asset and liability needs. In contrast to futures, the movement of collateral associated with bilateral swaps is negotiated and is highly dependent upon the credit worthiness of the counterparty because there is no clearinghouse.

After Title VII, there emerged the growing, nascent sphere of cleared swaps. Cleared swaps are like a hybrid between bilateral swaps and futures. The cleared swap is traded under an Addendum to the FCM Agreement. Depending upon the product, the swap may be required to trade on a Swap Execution Facility (SEF). An example of a cleared swap would be a credit derivative index product, called CDX, on U.S. corporate bond names. The product is standardized so it is traded as a swap but cleared on an exchange. Cleared swaps also exist with a distinct and separate collateral regime that is different from futures.

Each of these products, futures, bilateral swaps and cleared swaps have their own unique workflow in terms of documentation and onboarding, trading and execution, confirmations and reconciliation and collateral and resets.

How, Why, and the Extent to Which Pension Plans Use These Derivatives

Pension plans use exchange traded futures, cleared swaps and bilateral over-the-counter swaps in a variety of ways. I will limit my comments today to the cleared and bilateral swaps. Pension plans use these derivatives for a range of risk-reducing activities, in part because they are a cost-effective way of obtaining or eliminating specific exposure quickly. An example of risk reduction is the use of interest rate hedging by pension plans. Pension plans have both assets and liabilities (pension obligations to employees) to manage. Interest rate swaps, both cleared and uncleared, are an effective hedge against any potential volatile interest rate movements. If a plan has $5 billion in assets and $5 billion in liabilities, today, everything is balanced. However, if interest rates decline, this impacts the liability side and there will be a funding shortfall. Depending on the severity of that shortfall, under the worst of circumstances, it could strain the employer's balance sheet and give rise to solvency risk. The more likely scenario though is that it will require the employer to divert resources away from efforts that lead to economic expansion and job creation and into funding the pension shortfall.

This shortfall can be cost-effectively eliminated by employing interest rate swaps. Even in this low interest rate environment we are experiencing today, interest rate swap instruments can meaningfully reduce the volatility of the funded status of a plan. This is a powerful risk mitigant that we need to ensure can continue to be accessible by pension plans. Take for example a pension plan that has hired an investment manager to trade small capitalization stocks. They recently made a strategic decision to decrease the weight allocated to small cap stocks and move into intermediate corporate bonds. It will take a while for them to identify a new manager and transition the physical portfolio. The pension plan could buy derivatives, for example a total return swap that mimics the intermediate corporate bond benchmark index or a combination of interest rate swaps and index credit derivatives. In this way they obtain the desired exposure more quickly, cheaply and efficiently. To be clear, the cost-efficiency of this is a direct benefit to the pension plan participants.

Pension plans are a high quality credit counterparty. In the bilateral world, under ISDA documentation that is negotiated and managed between a pension plan and/or their investment advisor and a swap dealer, the pension is undeniably the stronger counterparty. With exchange traded swaps and futures, initial margin is posted by the client in an amount that is deemed by regulation or by the FCM to be of sufficient amount for a guarantee of contract fulfillment at the time a market position is established.[2] For bilateral swaps, the concept of initial margin is referred to as an independent amount. Indeed, the concept of posting collateral in the form of an independent amount for a bilateral swap is almost unheard of for a pension plan. Depending upon how the agreement was negotiated, there may even be unilateral payments. This means that because the pension plan is so creditworthy, that when

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[2] *http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/glossary_ijk.*

they owe a swap dealer on a payment, they do not pay the swap dealer, but if the swap dealer owes the pension plan, then the swap dealer makes the payment.

These examples highlight how swaps are used by pension plans often in risk reducing ways. The fact that pension plans are a high quality trading counterparty is also instructive. Keeping these concepts in mind, I move on to the changing (increasing) costs associated with derivatives use and developments that are affecting (negatively) pension plans' access to derivatives. I strongly believe that every pension plan should have a choice between how best to obtain synthetic exposure in a risk disciplined way, whether that be a future, cleared swap or bilateral swap. Pension plans, together with their strategic advisors have a fiduciary duty to thoroughly investigate, research and determine the most appropriate way to obtain their outlined investment objectives. Agents and fiduciaries like Russell can and do help pension plans and others navigate this.

Factors Driving Increasing Costs and Barriers To Access for Pension Plans To Use Derivatives

Costs surrounding cleared and bilateral swaps are both explicit and implicit. Tackling the explicit costs of the new era of cleared swaps, there have been and will continue to be additional costs borne as the result of introduction of this new product to the swaps solar system that previously only consisted of futures and bilateral swaps. As mentioned previously, cleared swaps require their own workflow. Cleared swaps do not replace anything *per se,* they add something entirely new. These situations surrounding workflows, from trading to collateral movements, directly impact pension plans and/or their investment advisors as well as the swap dealers—in the case of cleared swaps, the Futures Commissions Merchants (FCMs). As of January 31, 2015, the CFTC Financial Data for FCMs report reflects 74 FCMs with just 23 of them supporting cleared swaps.[3] There have also been some high profile FCM exits from the cleared swaps business.[4–5]

At this point I would like to provide a recent, dramatic example of the dynamic of increased costs. A pension plan client of Russell's, one that is active in the futures, cleared swaps and bilateral swaps arenas is facing significant rising costs. Russell is an agent, fiduciary, and investment advisor for the pension plan and trades cleared swaps and futures with one FCM. Their book in gross notional size is a few billion dollars in futures and cleared swaps. On the cleared swaps side, their fees with the FCM had been a per ticket (*i.e.,* one order for $300 million would be one trade ticket) charge of between $250 and $500. If the pension plan traded, assume twice a month a variety of different cleared products, those charges on an annualized basis were equivalent to about $25,000. The FCM citing a number of different regulatory pressures recently presented Russell with a revised fee schedule that represented fees, on an annualized basis, based upon their current portfolio, of $550,000. We've now moved into the fee stratosphere. This is an unwelcome byproduct of this new solar system and one that not only significantly reduces the cost-efficiency of these highly useful and important instruments, but it also may be so cost prohibitive to most clients (particularly midsize or smaller clients) that those clients are priced out of the market. That is a tradeoff between certain costs and uncertain (but potentially significant) funding risk that will face all pension clients.

Implicit costs abound everywhere. With new legal definitions, trading venues and addenda to append FCM agreements all attached to derivatives regulation, significant time energy and resources have been spent. Investment Management Agreements (IMAs) have also had to be revised. In 2012, I spent numerous hours explaining to pension plans why they need to register and maintain a LEI (Legal Entity Identifier) and its predecessor the CICI (CFTC Interim Compliant Identifier). Countless hours have also been spent trying to navigate the new world of Special Entities that pension plans invariably became a part of with new regulation. Never has a seemingly innocuous question like "are you a U.S. Person?" been so loaded with meaning, complexity, and work.

There are other more subtle implicit costs for pension plans. With pension plans, advisors and swap dealers all working together to ink new agreements and documents, whereas in the past certain terms or rights were negotiated carefully, that approach was difficult to replicate this time around. The timelines for cleared swaps implementation required that documents be fully executed and "operationalized" well ahead of the start date for each category of derivative end-users. Similarly, in

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[3] *http://www.cftc.gov/ucm/groups/public/@financialdataforfcms/documents/file/fcmdata0115.pdf.*

[4] *http://www.thetradenews.com/news/Trading__Execution/Industry_issues/EMIR_delay_prompts_BNY_Mellon_clearing_exit.aspx*

[5] *http://finance.yahoo.com/news/rbs-wind-down-swaps-clearing-091729703.html.*

very short order, end-users were left to discern whether to be a Swap Execution Facility (SEF) member directly or not. All of these examples had the potential to collide in the swaps solar system, and it took an enormous amount of effort to remain in orbit. The degree to which each of these affected a pension plan was largely determined by the instruments that they were using. Based on my own experience and observations, if a pension plan was using futures and bilateral OTC swaps, it was certainly going to use cleared swaps. However, if a pension plan was only using futures and now had the ability (after signing more documentation) to use cleared swaps, they would choose to stick to using just futures. In other words I would have thought there would be more pension plans emerging as new end-users of cleared swaps by now, but that has, so far, not been my experience.

There are always growing pains associated with big dramatic change and Russell is cognizant that costs are associated with change. We are also aware of the long-term benefits and value of swaps and respectful of the policy goals of transparent markets. The few points I have mentioned about costs both explicit and implicit are extremely important in the context of having a liquid and well-functioning marketplace. Pension plans and other end-users of derivatives benefit from cost efficient ways to obtain their exposures.

Some cost pressures associated with derivative use by pension plans are a direct result of some unintended consequences that are created when considering the implications of different global regulations. This is the last area I would like to mention.

Summary of a Few Areas of Concern and Thoughts on How To Address Emerging Challenges

There are a lot of things in orbit in the new swaps solar system that I have outlined. Pension plans are a high quality credit worthy counterparty in the bilateral OTC swaps construct and play a key role in diversifying customer types for an FCM. FCMs are adapting and changing their own business models. The broad implications of international banking regulations such as Basel III have caused FCMs to re-evaluate the profitability of not just cleared swaps, but futures as well. FCMs are being increasingly more discerning about what products they want to facilitate, under what conditions they will trade and importantly with what type of client they will accept. Though a certain amount of this is healthy and expected, and is the price to pay for transparency, there have been some unintended consequences. Those include (1) increasing fragmentation; (2) reduction in competition as some FCMs exit; (3) increased concentration; (4) increased costs that erode pension or corporate resources; and (5) reduced access as certain client types and sizes are potentially unprofitable for FCMs to face. The combination of these variables creates a situation where pension plans are unable to use risk reducing instruments. Ironically, due to a combination of factors surrounding capital ratios that impact FCMs, pension plans and the type of stable real money accounts they represent are becoming less desirable clients to both swap dealers and FCMs.

Though highly technical in nature, the U.S. implementation of Basel III's Supplemental Leverage Ratio, the Net Stable Funding Ratio, the Liquidity Coverage Ratio, and the risk weights of certain assets are just a few of the calculations that can severely impact the cleared and bilateral swaps pension plans utilize. Where a pension plan is located and what jurisdiction it operates under can also be a key component for determining if a robust legal netting opinion can be obtained from counsel in order to be considered a Qualified Master Netting Agreement under Basel III. The problem some pension plans are at risk of facing, is that if an unqualified legal opinion cannot be obtained, then the swap dealer must account for the pension plan's derivative exposures on a gross basis. This creates a situation where trades by the affected pension plans become either prohibitively expensive to enter, or alternatively, those pension plans are not offered certain products at all. In other words, affected pension plans cannot engage in offsetting risk or reducing risk exposures. This at best significantly increases costs and at worst paradoxically creates a situation where pension plans are less desirable as clients for an FCM or swap dealer. The issue is multi-faceted, but the industry is willing to work with prudential regulators to help remove artificial barriers that only serve to hinder pension plans' use of derivatives.

Another area of concern surrounds the aggregation across affiliates of exposures for the margin of uncleared swaps. It may be worth reiterating the high quality nature of the creditworthiness of pension plans. As it is rare that a pension plan posts an independent amount associated with an uncleared swap today, I believe pension plans should be exempt from posting in the future. However, under the current proposed rules surrounding the calculations used to determine who should be posting initial margin, it is necessary to aggregate exposures. Interestingly, these proposed

rules differ significantly from the Major Swap Participant (MSP) rules already in place. Aligning these rules with the MSP rules already in place could be one possible solution to explore. At Russell, we have a number of different pension plan clients. Those pension plans hire Russell to do very specific things. That same pension plan hires many other investment managers that all have their own unique mandates. The pension plan is the beneficial owner and technically the end-user of the derivative. The challenge is trying to assess and roll up all of that derivative exposure. Russell does not have any knowledge of what other managers are doing or what other derivative exposures are present.

Certainly there are other areas of concern. However, various Basel III elements that conspire to make the business less profitable for swap dealers and FCMs also create the unintended consequence of making pension plans appear less desirable as customers. The aggregation issue serves to highlight how some rules are not consistent in their approach and how difficult it is in practice to collect information considering the separate and limited recourse inherent in pension plan structures. To summarize and conclude, I have so far attempted to describe broadly, the use of derivatives by pension plans, some concerns surrounding the increased costs for pension plans that use derivatives and highlight just a few areas of concern. As the new swaps solar system evolves and continues to revolve, Russell is hopeful that certain elements can be fixed along the way to make sure pension plans and other market participants can keep humming along in orbit. We are hopeful that with careful consideration and help the derivatives marketplace will continue to evolve in a way that ensures access and transparency for use by pension plans.

The CHAIRMAN. Thank you.

Mr. Maurer.

STATEMENT OF MARK MAURER, CHIEF EXECUTIVE OFFICER, INTL FCSTONE MARKETS, LLC, CHICAGO, IL

Mr. MAURER. Chairman Scott, Ranking Member Scott, thank you for having me here today. I appreciate the time, and it is an honor being here.

My name is Mark Maurer. I am from the State of Kansas and moved to Chicago about 13 years ago. My background is primarily in the risk management side, but I also have experience in operations and trading. I work for INTL FCStone Markets, which is a subsidiary of INTL FCStone, Inc., a publicly traded company listed on the NASDAQ. I will refer to INTL FCStone Markets as IFM for the rest of this testimony.

We were the first non-bank swap dealer to register with the CFTC, and our business is built on servicing the commercial end-user; our customers, offering them the ability to hedge their commodity exposures.

Who are these customers? We are talking about the soybean co-ops in Illinois, we are talking about the corn co-ops in Iowa, we are talking about the cattle ranchers in Texas. The majority of our business is helping the farmers of America hedge their commodity exposures.

The markets we are discussing today were built for the end-users; that is why they are in existence. Today, we are here to discuss a few different proposals from the CFTC that were intended to prevent systemic risk in our industry. We believe we are in a stable and growing industry when it comes to the farmers of America and their ability to hedge their commodity-based risk, but if these rules are finalized as proposed, our customers will either lose their ability to hedge as they have in the past, or their hedging costs will be much greater.

First, I will talk about the CFTC's proposed margin rules. One of the reasons we are currently able to give our customers great

pricing is because we are able to use the margin delivered by customers to finance the offsetting hedge to support the customers' trade. Without these offsetting hedges, we would be adding systemic risk to the industry. We believe our customers should have the ability to choose whether their margin should be used in this manner. Last year, we offered our customers the choice as to whether to instead hold their margin in a segregated account. Not one of our customers made this election, as the cost of using segregated accounts were, in their view, unnecessary, but the CFTC's proposed rule would have required holding these funds in separate accounts. Under the proposed rule, not only the cost of setting up the margin accounts, but also the cost of the offsetting hedge will have to be passed onto the customers, which will make it less appealing for them to hedge and, therefore, add systemic risk to the industry.

Now, let us talk about the CFTC's proposed swap dealer capital rule. We are 100 percent in favor of having a fair capital requirement that applies to all swap dealers, both banks and non-banks. In Chairman Conaway's remarks at the recent Futures Industry Association conference, he said that regulatory burdens should be both minimalized and justified.

What does this proposed capital rule mean for our customers? Our customers continually think about price risk, basis risk, volatility risk, and credit risk, but they also are affected by regulatory risk.

We appreciate the acknowledgement, as was included in the Committee's bipartisan CFTC reauthorization bill of the last Congress, that the CFTC's proposed rule for non-banks *versus* banks were not fair and needed to be addressed. For example, a position that a bank swap dealer has on that requires a capital usage of $10 million would require a non-bank swap dealer to have upwards of $1 billion of regulatory capital set aside. This large difference will significantly impact the regulatory risk incurred by our customers. Why is there such a large difference? Under the CFTC's proposed rule, bank affiliate swap dealers are allowed to use their own internal models to calculate their capital requirements, but non-bank swap dealers are not permitted to use internal models in the same way. Non-bank swap dealers must calculate their capital based on a formula created by the CFTC. This formula does not permit netting, except for identical offsetting positions. For example, if IFM has a short $10,000 March swap corn position, and a $10,000 long swap position in May contrast, this would constitute a $20,000 gross exposure and there would be no netting. But as all of us know, a March–May spread is actually less risky than an outright March or an outright May contract.

Coming up with a solution that is fair for non-bank and bank swap dealers is in the best interest of our industry and our customers. And remember, our midmarket customer base may not have a wide range of solutions that larger players in these markets have, but these customers are our core client base. If a solution is not found to make these capital rules equitable, our customer base and the farmers of America may lose many of their competitive choices to hedge.

In closing, thank you for your time. I would like to reiterate that we are currently in a stable, growing industry that allows us to manage risk for our farmers in America. We as a group need to come up with a solution to keep it that way.

Thank you.

[The prepared statement of Mr. Maurer follows:]

PREPARED STATEMENT OF MARK MAURER, CHIEF EXECUTIVE OFFICER, INTL FCSTONE MARKETS, LLC, CHICAGO, IL

Chairman Austin Scott, Ranking Member David Scott, Chairman Conoway, Ranking Member Peterson, and other Members of the Committee and Subcommittee, thank you for inviting me to testify at this important hearing. I am the Chief Executive Officer ("CEO") of INTL FCStone Markets, LLC.

Prior to my current role, I was the Head of Risk for one of the leading Agricultural trading firms in Chicago. It is there that I began to understand how important it is for the farmers of America, our customers, to have the ability to hedge their exposures. I have served in various capacities, which include derivatives, operations, trading and sales and I enjoy looking at the business from every view point.

What I am going to share with you today builds upon the testimony provided on May 21, 2013 by my colleague William Dunaway, Chief Financial Officer of INTL FCStone Inc., before the U.S. House Committee on Agriculture's session on "The Future of the CFTC: Market Perspectives."

Above all, INTL FCStone is here to advocate for our customers, for regulations to be finalized in a way that will continue to allow even the smallest end-users to have access to firms like ours, to hedge against market risk, in a cost efficient way.

I. INTL FCStone's Evolution Servicing Agricultural Customers

INTL FCStone Inc. (collectively with its affiliates, "we" or "INTL FCStone") is a publicly held, NASDAQ listed company that dates back to 1924 when a door-to-door egg wholesaler formed Saul Stone and Company. This company went on to become one of the first clearing members of the Chicago Mercantile Exchange. In June of 2000, Saul Stone was acquired by Farmers Commodities Corporation, which at the time was a cooperative owned by approximately 550 member cooperatives, and was renamed FCStone LLC. In 2009 we merged International Asset Holding Corp. and FCStone Group, becoming a global financial services organization. We currently maintain more than 20,000 accounts representing approximately 11,000 customers located in more than 135 countries through a network of 37 offices around the world and employ approximately 1,100 professionals.

INTL FCStone offers its customers a comprehensive array of products and services, including our proprietary Integrated Risk Management Program, exchange-traded futures, OTC derivatives execution and access to different commodity markets and asset classes. Our products are designed to help customers limit risk, reduce costs, and enhance bottom-line results. We also offer our customers physical trading in select soft commodities including agricultural oils, animal fats and feed ingredients, as well as precious metals. In addition, we provide global payment services in over 130 foreign currencies as well as clearing and execution services in foreign exchange, unlisted American Depository Receipts and foreign common shares. We also provide securities broker-dealer and investment banking advisory services.

From its early beginnings up to the present, INTL FCStone has predominately serviced midsized commercial customers, including producers, merchandisers, processors and end-users of virtually every major traded commodity whose margins are sensitive to commodity price movements. Our largest customer base is serviced from offices in the agricultural heartland, such as West Des Moines, Iowa, Omaha, Nebraska, Minneapolis, Minnesota and Kansas City, Missouri. We are successful because we are a customer-centric organization, focused on acquiring and building long-term relationships with our customers by providing consistent, quality execution and value-added financial solutions.

The primary markets we serve include: commercial grains; soft commodities (coffee, sugar, cocoa); food service and dairy (including feedyards); energy; base and precious metals; renewable fuels; cotton and textiles; forest products and foreign exchange. Our offices are located near the customers we serve and our customers are the constituents of the Members of this Committee—the farmers, feedyards, grain elevator operators, renewable fuel facilities, energy producers, refiners and wholesalers as well as transporters who are in involved in the production, processing, transportation and utilization of the commodities that are the backbone of our econ-

omy. As an example, we believe our customers handle more than 40% of domestic corn, soybean and wheat production, including 20% of the grain production in Texas, 40% of grain production in Kansas, and 50% of grain production in Iowa and Oklahoma.

We offer our customers sophisticated financial products, but are not a Wall Street firm. Our mid-sized Futures Commission Merchant ("FCM"), FCStone LLC, according to recent industry publications, is the 20th largest FCM based upon customer segregated assets on deposit. However, it is the fifth largest independent FCM not affiliated with a banking institution or physical commodity business.

INTL FCStone Markets, LLC ("IFM"), a subsidiary of INTL FCStone Inc., is a member of the National Futures Association ("NFA") and registered with the U.S. Commodity Futures Trading Commission ("CFTC") as a Swap Dealer. IFM was one of the first to register as a Swap Dealer and at the time, we were the only organization not affiliated with a bank to register.

Although the INTL FCStone Inc. group of companies conducts a global full-service, integrated commodities, futures, investment banking, derivatives trading and risk-management business, we remain unique, in that we are still not affiliated or owned by a bank and we primarily serve the worldwide commercial mid-market agricultural community.

It is in this capacity that we come before the Committee and request that this Committee ensure that the laws passed by Congress, and the regulations of the CFTC, are beneficial to the end-users that are our customers.

II. INTL FCStone Supports the Goals of the Dodd-Frank Act & the CFTC's Mission to Protect End-Users

INTL FCStone continues to support the goals of the Dodd-Frank Act aimed at promoting customer protection, and reiterates its support for the CFTC's continued mission to protect derivatives customers and provide end-users with market certainty. This can be accomplished by promulgating laws and regulations that help farmers, merchandisers, and end-users to effectively manage risks in a cost-efficient manner. In particular, we supported Section 356 of the previous Congress' H.R. 4413, the Consumer Protection and End User Relief Act, a bipartisan bill passed by the House of Representatives last Congress. We supported the Bill because it will create a level playing field for non-bank Swap Dealers like FCStone, rather than discriminate against commodity Swap Dealers who are not affiliated or owned by a bank.

The heart of our business is making available to our customers access to futures and OTC derivatives through our affiliated FCM and our Swap Dealer. We make a market for customers who transfer their risk to us, and we in turn need to create an opposite trade in the market so that our position and the risk associated with that position remains neutral. A provision such as Section 356 of H.R. 4413 will allow us to do this without prohibitively increasing our capital costs. Otherwise, these costs would need to be passed on to our customers, impeding market efficiency by making it too expensive for farmers and other end-users to hedge their exposures.

III. Capital and Margin Rule Proposals Treat of Swap Dealers Not Affiliated or Owned by Banks Unfairly Compared with Bank-Owned Swap Dealers

A. Proposed Capital Rule

Ensuring that swap-dealers have an adequate capital base and that customer collateral arrangements do not add to systemic risk are positive and commendable objectives of Dodd-Frank. However, the capital and margin regulations, as proposed by the CFTC, would significantly disadvantage Swap Dealers that, like INTL FCStone, are not affiliated with a bank, in favor of bank-affiliated Swap Dealers that perform the same market functions.

As we have previously highlighted in our testimony of May 21, 2013, the competitive advantage given to bank-affiliated Swap Dealers under proposed rules is extraordinary. IFM will be required to hold regulatory capital potentially hundreds of times more than that required for a bank-affiliated Swap Dealer for the same portfolio of positions. This disparate treatment to non-bank Swap Dealers like IFM is in part because the proposed rules allow bank-affiliated Swap Dealers to use internal models to calculate risk associated with customer positions, while IFM and other non-banks cannot use their internal models. These models are in some cases the very same models used by the banks.

The use of internal models is important because internal models generally provide for more sophisticated netting of commodity positions to determine applicable market risk capital charges. As a result of limited netting under the CFTC's "standard-

ized approach," a non-bank Swap Dealer will have to hold market risk capital against economically offsetting commodity swap positions, resulting in a higher capital requirement overall[1] relative to the capital requirement for a bank-affiliated Swap Dealer using an internal model.[2] This increased capital requirement would have the perverse effect of actually incentivizing a non-bank affiliated Swap Dealer to not fully offset the risk of a customer OTC transaction and thus incurring potentially unlimited market risk.

Under the "standardized approach" proposed by the CFTC to calculate Swap Dealer capital requirements, which is based on European banking standards (*i.e.,* Basel II), many of the commodity derivatives that we make available to our agricultural customers are subject to higher capital requirements than any other derivatives asset class. Agricultural products are at the heart and soul of the U.S. and global infrastructure, and requiring more capital for derivatives in agricultural products is counterproductive to the hedging needs of America's agricultural businesses. We will have to hold more capital for agricultural products than interest rate swaps, because the rules treat "commodities" disparately from other asset classes, and in addition, as a non-bank Swap Dealer, we will not be allowed to use our internal models, simply because we are not affiliated with a bank.

Taken in conjunction, the same derivatives portfolio that would require a bank-affiliated Swap Dealer to hold $10 Million in regulatory capital using standard internal models would require us to set aside up to $1 Billion in capital in a worst case scenario. Regulatory capital requirements of this magnitude are wholly unsustainable for a company of INTL FCStone's size. The numbers are not economically feasible for a company of any size. Calculations supporting these estimates are attached to this testimony as *Addendum A.* INTL FCStone submitted these same calculations to the CFTC with our comment letter on this issue.

As previously mentioned, INTL FCStone was the first non-bank to register as a Swap Dealer. As other non-banks register, particularly those in the agricultural and energy space, additional market participants will be caught in this position and either squeezed out of the market, or at least seriously disadvantaged relative to the bank-affiliated dealers.

Obviously, this regulatory capital disparity is not a small hurdle for the already disadvantaged independent dealers to overcome. If left unchanged, these capital rules will eventually cause nonbank Swap Dealers to exit the business. The direct result will be higher costs for end-users, and then for consumers. Increasing concentration in the industry until only the big banks are left will leave many customers with no place to go. Serving farmers, ranchers and grain elevators has not been a focus or a profitable business model for the large dealers.

Even larger customers who might be able to access to OTC hedging tools through bank-affiliated dealers will still face higher costs as the big bank dealers will be able to take advantage of decreased market competition. A larger percentage of customers carried through a handful of large, bank affiliated Swap Dealers will increase systemic risk.

FCStone still believes every Member of this Committee would agree that the CFTC rules were not intended to preclude small commodity producers from hedging. Nor were the rules intended to concentrate swap activity at the banks, which would increase the potential for systemic risk. That said, that is the result that will follow if the capital and margin rules are adopted as proposed.

How do we solve this problem? By complying with the mandate under the Commodity Exchange Act which requires the CFTC, the prudential regulators, and the SEC to establish and maintain "***comparable***" minimum capital requirements ***for***

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[1] Dealers should depend primarily on spreads between transactions for earnings, not on directional price change speculation. This is an underlying intent of many provisions of Dodd-Frank (*e.g.,* the Volcker Rule). In the ordinary course of their operations, Swap Dealers relying on spreads are incentivized to run flat books, which in turn reduces risk in the market. Based upon our conversations with staff, we understand that the CFTC does not intend to allow Swap Dealers to recognize commodity position offsets as to maturity and delivery location. If this is true, it seems counterproductive from a capital and a risk standpoint. A capital rule that adequately risk-adjusts offsetting positions would properly incentivize Swap Dealers to run flatter portfolios (thereby decreasing systemic risk) because the Swap Dealer would be able to lower its capital requirement by entering into offsetting positions.

[2] We consider it significant that the SEC's proposed rules on capital, margin and collateral segregation for non-bank Security-Based Swap Dealers and non-bank Major Security-Based Swap Participants permit the use internal value-at-risk models. We believe the CFTC will foster productive end-user markets if they take a similar approach with their capital and margin rules. Consistent CFTC and SEC rules will also allow Swap Dealers who have SEC-regulated affiliates to operate more smoothly, with a risk program that applies across all affiliated entities.

all Swap Dealers. We have asked the regulators to address the fact that the proposed Capital & Margin Rules are not "comparable." We urge Congress to ensure the CFTC's proposed rules ensure capital and margin requirements that apply to non-bank Swap Dealers are in fact, comparable to those applicable to bank-affiliated Swap Dealers, and to refrain from creating a commercial disparity based on the commodity asset class, and commodity end-users. This can be accomplished by altering the rules to permit the following:

- **Internal Models.** We believe the CFTC could permit all Swap Dealers, including Commodity Swap Dealers, to request approval of, and rely upon, internal models to measure market risk. The language in the previous Congress' H.R. 4413 would have accomplished this task. To the extent that the CFTC currently lacks the resources to review and approve such internal models, it should permit Swap Dealers to certify to the CFTC or the NFA that their models produce reasonable measures of risk, subject to verification by the CFTC when its resources enable it to do so;
- **Full Netting.** We believe that to the extent a Swap Dealer is unable to rely on an internal model, the CFTC should revise the "standardized approach" in the CFTC's proposed capital rules to clarify that it allows full netting of offsetting commodity swap positions, which will create a capital requirements framework that is more similar to the prudential regulators;
- **Matched Position Offsetting.** Alternatively, the CFTC could allow position offsetting for "matched positions," either on a per commodity/per expiry basis, or by using a "maturity ladder" approach to netting, as described in the Basel Committee's Amendment to the Capital Accord to Incorporate Market Risks (the "Market Risk Amendment"), in order to facilitate the netting of commodity swap positions; or
- **Flat Book Incentives.** Default risk is reduced when an entity maintains a relatively flat book. We believe the CFTC should incentivize dealers to reduce default risk by decreasing capital requirements for operating a flat book. This incentive can be achieved by revising the Capital Rules to recognize netting for economically offsetting commodity swap positions (whether through the maturity ladder approach, or otherwise). Under the current proposal, dealers get no credit, from a capital perspective, for running a flat book and in fact are penalized.

B. Proposed Margin Rule

Similar to the unintended effects of the Swap Dealer capital rule, the CFTC's proposed swap margin rules will have a negative impact on end-users because of the difficulty that Swap Dealers will have in complying with it. The cost to the Swap Dealer will inevitably passed on to the Swap Dealer's customers.

Customer protection tools, such as segregation of customer funds and prompt transfer of those funds to customers in the event of a bankruptcy, are core protections in the Commodity Exchange Act. At the same time, customers are capable of exercising discretion to choose whether to opt-in or opt-out of certain protections. For example, the CFTC permits customers to elect whether to require or not require segregation of margin for uncleared swaps. In order to set up a segregated margin account for an individual customer, a bank will typically charge directly to the customer an amount that ranges from $10,000–$20,000 per account, per year, plus one-time set up fees up to $6,500. These fees are not in the discretion of the Swap Dealer and must be borne by the customer. All of INTL FCStone's swap customers elected not to segregate margin with a third party custodian unaffiliated custodian. Our customers indicated that they were comfortable with FCStone's credit as swap counterparty, and they did not agree that the cost to them of having an independent custodian bank 'lock-up' their margin was worth the remote eventuality that FCStone would become bankrupt and be unable to return their assets.

In the CFTC's most recent proposal regarding margin, however, INTL FCStone and certain of its customers would have been required to incur these excess costs, due to the CFTC's segregation requirement for trades with customers that met specified exposure thresholds.

Also, similarly to the CFTC's proposed Swap Dealer capital rules, the proposed margin rules do not permit Swap Dealers (whether or not affiliated with a bank) to calculate their margin requirements using internal models. This increases costs to the Swap Dealer, which must be passed on to the customer, and also increases the customer's direct costs, since under the CFTC rules Swap Dealers are required to collect margin from their customers. As we stated in our letter to the CFTC dated December 2, 2014, continued increases in the cost of hedging could have the counterproductive result of driving customers out of the markets altogether, leaving

them with unexposed risk. We requested the following modifications to the margin rule:

- **Calculation of Initial Margin.** We believe the CFTC should limit the posting and segregation of excess margin by allowing Swap Dealers and major swap participants (collectively, "***Covered Swap Entities***" or "***CSEs***") to submit margin methodology filings as self-executing filings if the methodologies have previously been approved on behalf of their affiliates by other regulators, including foreign regulators that have implemented margin regimes consistent with the BCBS–IOSCO Margin Requirements for Non-Centrally Cleared Derivatives (the "***BCBS–IOSCO Framework***").[3] We also believe that the CFTC should encourage the use of standardized models developed by industry groups by allowing CSEs to submit such models as self-executing filings if they have been approved for use by another market participant.
- **Re-Use of Posted Margin.** The Proposed Rules do not permit initial margin ("IM"), which must be held by a third-party custodian, to be rehypothecated, repledged, or reused. Customers, given the choice, do not chose this option, as we observed when we gave this option to our customers. The margin rules should instead permit reuse of posted margin if the relevant model meets the standards proposed in the BCBS/IOSCO Framework. In addition, the Department of the Treasury, the Federal Reserve and other prudential regulators (the "***Prudential Regulators***") and the Securities and Exchange Commission may permit reuse of posted margin,[4] and if so, a prohibition by the CFTC will create a competitive disadvantage for market participants regulated by the CFTC.
    - ○ According to the BCBS–IOSCO Framework, IM collateral posted to a CSE may be re-used by the CSE to finance a hedge position associated with a counterparty's transaction, so long as applicable insolvency law gives the posting counterparty protection from risk of loss of IM in the event the CSE becomes insolvent. If such protections exist, and a financial end-user consents to having its IM reused, then a CSE may re-use IM provided by a financial end-user or another CSE one time to hedge the CSE's exposure to the initial swap transaction.
    - ○ The reuse of IM collateral can efficiently reduce the cost of non-cleared swaps for U.S. financial end-users, because it allows CSEs to hedge their exposures. For example, a CSE selling non-cleared credit swap protection to a financial end-user counterparty could re-use the IM that it receives from that transaction to buy noncleared credit swap protection from another counterparty. As a result, allowing for the reposting of IM can reduce the liquidity burden on CSEs when they enter into offsetting positions, thereby reducing transaction costs for derivatives users. Moreover, because U.S. bankruptcy laws protect U.S. financial entities in the case of an insolvency of the covered swaps entity, and the collateral may only be reused once for hedging purposes, aligning the Proposed Rules with the BCBS–IOSCO Framework in this respect would not expose U.S. financial entities to any undue risk.
    - ○ As you can see, the ability to reuse margin in this manner is particularly important for mid-market non-bank Swap Dealers like IFM. Such mid-market Swap Dealers would not reuse margin to engage in proprietary trading or securities lending, but need the ability to use margin to finance hedges directly related to their customer-facing trades. Such hedges are beneficial to customers, as they are entered into in order to enable the Swap Dealer to fulfill its obligations under customer-facing transactions. Thus, we believe that a restriction on re-use of posted margin will actually add to market risk. On the other hand, if mid-market Swap Dealers are permitted to use IM to finance hedge activity, on the condition that the hedge is directly related to the underlying customer and the specific trade at hand, then this activity will mitigate transaction risk and market risk.
    - ○ If mid-market non-bank Swap Dealers are required to independently post IM to an exchange or counterparty, rather than utilize customers' IM, then such Swap Dealers would have to borrow from external sources, at a cost, in order to fund the posting of the IM. The cost to the Swap Dealers, would in turn, be passed on to their counterparties. Although the margin rule is intended

[3] Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, *Margin Requirements for Non-Centrally Cleared Derivatives,* September 2013, available at *http://www.bis.org/publ/bcbs261.pdf.*

[4] See *Margin and Capital Requirements for Covered Swap Entities; Proposed Rule,* 79 FED. REG. 573458 at 57374 (September 24, 2014).

to manage systemic risk, an unintended consequence of the rule for mid-market Swap Dealers and their end-user customers would be that transaction costs will increase. As a result, the Proposed Rules may cause certain market participants to be squeezed out or otherwise unwilling to tie up capital, leaving those market participants with unhedged risk.

- For the forgoing reasons, we suggest the CFTC revise the Proposed Rules to be consistent with the BCBS–IOSCO Framework and permit the reuse of IM where (i) applicable insolvency law affords protection from risk of loss of IM if the Swap Dealer becomes insolvent, (ii) where the hedge is directly related to the underlying customer and the specific trade at hand, (iii) where the reuse is not in connection with proprietary trading or another customer's trade, and (iv) where the customer consents.

IV. Customer Issues

A. Three Key Principles

Chairman Michael Conaway highlighted three key principles in his remarks at the Annual FIA Conference recently: (i) the derivatives markets grew up in response to the needs of hedgers; (ii) regulatory burdens should be both minimized and justified; and (iii) regulations should provide clarity and certainty.

i. Derivatives Markets Grew Up in Response to the Needs of Hedgers Who Are Farmers, Merchandisers and Producers

We are called upon by end-users faced with the risk that the commodity they grow, for example, may not grow in the amount anticipated or required, or be capable of being delivered as planned or be priced as anticipated or bought or sold as planned. These risks faced by commercial end-users are unique to them. To help these markets grow at a natural pace, allow the market activity to drive what rules are relevant to this market, not the other way around. And certainly do not impose rules designed for banks, speculators or institutional customers onto farmers, merchandisers, producers and other end-users.

ii. Minimize and Justify Regulatory Burdens and Costs

We believe the CFTC should develop rules in consultation with end-users before proposing or implementing them. Closer coordination with end-users will help create better rules, and can provide the CFTC with important, relevant information about market practice, as well as the costs associated with a proposed rule. Rule changes require legal and compliance expertise to assess and understand the rule itself, and depending upon the complexity of the rule, greater and ongoing legal and compliance expertise is needed. Rules need to be operationalized and can impact multiple business units, and require costly changes to existing business models. Staffing requirements can also change due to changes in rules, both with regards to staff expertise and number.

While the recent Basel committee decision to postpone the implementation dates for the margin rule will be helpful, the problems with the substance of the margin rule remain. Therefore, we believe the CFTC should modify the margin and capital rules as we have outlined. Otherwise, as proposed, the rules will cost end uses an exorbitant amount of money to hedge a commercial risk.

Rules should be responsive to a problem that actually exists or that is demonstrated to be imminent, rather than a theoretical problem or a problem whose eventuality is remote. Complex rules have been accompanied by complex exceptions, placing new burdens on end-users to try to understand both the complex rule and whether they satisfy the exception, which is fraught with complex conditions and tests. Implementing rules without consultation with end-users has required the CFTC to react after the implementation of final rules, by issuing no-action letters and interpretive guidance, which creates additional burdens on CFTC resources as well as market participants. This complexity is unnecessary given the relative simplicity of the agricultural end-users conduct in the market and the manner in which they utilize derivatives.

iii. Regulations Should Be Clear and Provide Certainty

Not only farmers, manufacturers, and other end-users, but the industry as a whole have struggled to comply with many rules because they are too complex to understand. The extraordinary number of no-action letters (170), plus interpretations or "guidance" that the CFTC issued to try to clarify its rules (60 new rules finalized by the CFTC since Dodd-Frank was enacted) evidences that the rules were overly complex, not always relevant to the product or business they were aimed to regulate, were overly restrictive, or not inclusive enough or time-limited in nature.

B. The CFTC's Cross-Border Guidance

The CFTC's cross-border guidance proved to be overly complex, resulting in industry challenges and culminating in litigation. We support recognition of non-U.S. regulators' interest in regulating their own markets, with deference to regulators that have comparable regulatory regimes. Better foreign relations are needed going forward to have a cohesive, global swap market.

V. Conclusion

As we expressed in 2013, INTL FCStone is not interested in dismantling Dodd-Frank. We are simply trying to help ensure that final rules reflect that commercial end-users, and the firms like INTL FCStone who serve them, are not subject to rules that prevent them from successfully hedging risk.

Unless the proposed margin and capital rules are changed to be comparable to the rules for bank-affiliated Swap Dealers, we, and as a result, our customers, will have to assume extraordinary financial burdens that place us at a competitive disadvantage. Without the changes we propose, the consequences of the rules will be forced on our customers, who will have no alternatives to hedge elsewhere.

We will continue to work with the regulators to ensure that we and firms like INTL FCStone will be here well into the foreseeable future to help our customers manage their risk. We are here to advocate for our customers regulations drafted in such a way that will continue to allow even the smallest end-users to have access to hedge against market risk.

Thank you for inviting me to testify today. INTL FCStone greatly appreciates the ongoing work and support that the Committee has provided and continues to provide during these challenging times for our nation, and I look forward to answering any questions that you may have.

APPENDIX A

The purpose of this *Appendix* is to provide a detailed illustration of the netting of offsetting exposures described in the comment letter. For the sole purpose of this illustration, we have put together the below hypothetical portfolio which contains both OTC and centrally-cleared corn swaps, swaptions, futures and futures options. This is not the same portfolio used for the calculations noted in the comment letter, but rather a much smaller and single commodity portfolio.

For simplicity, this illustration only covers the market risk charges applicable to 15% directional risk on the net position and the 3% of "gross" to cover forward gap, interest rate and basis risk. The Maturity Ladder Approach (iv) and Internal Models (VaR) (v) are excluded from this illustration. The initial offsetting allowed under the Maturity Ladder Approach is the same as reflected in (iii) below although the resulting charges would be slightly less due to lower charges (1.5%) for offsetting exposures within a broader "Time Band".

Corn

Position	OTC	Delta
A	Long 50 December 2013 swaps	250,000
B	Long 100 December 2013 5.50 puts	(164,379)
C	Long 250 December 2013 6.50 calls	518,800
Position	**Central Clearing Counterparty**	**Delta**
D	Short 150 December 2013 futures	(750,000)
E	Short 100 December 2013 5.50 puts	(164,384)
F	Short 25 March 2013 6.91 puts	59,762
G	Short 25 March 2013 6.91 calls	(65,199)
H	Short 25 July 2013 6.92 puts	57,717
I	Short 25 July 2013 6.92 calls	(65,199)

Definitions of fields used in the below illustrations:

Underlying Group—the underlying commodity upon which the position is based.

Positions Included—the positions from the above portfolio that are included in each line. This really helps to illustrate how the netting described is working.

Contract Month—the delivery month of the underlying on which the position is based.

Option Type—Call, Put or, in the case of swaps and futures, N/A for the position shown.

Strike—The strike price for the position shown.

Delta—the underlying equivalent size of the position expressed here, not as futures equivalents, but notional quantity (*i.e.,* Notional Delta). In this illustration using corn, the delta is expressed in bushels. To derive the futures contract equivalent size, simply divide the number shown by 5,000.

Spot Price—in this case, the spot price of corn used in the calculations as prescribed by the proposed rules.

Delta Notional—derived by multiplying Delta * Spot Price. This is the notional value of the based upon the delta as prescribed to do in the *Amendment to the Capital Accord to incorporate market risks* page 31 under Delta-plus method.

15% Net Charge—this calculation only applies to the net remaining position and is the capital charge for directional risk. It is derived by multiplying to total net Delta Notional by 15%.

3% Gross Charge—this value is derived by multiplying the absolute value of Delta Notional by 3% per line item. This is the only charge which will vary between the examples below and is dependent upon what is allowed to offset/net.

(i) Standardized Approach with *no* offsetting—Same methodology used in Row 1 of the comment letter

Underlying Group	Positions included	Contract Month (MMM–YY)	Option Type	Strike	Delta	Spot Price	Delta Notional	15% Net Charge	3% Gross Charge
Corn									
	A	Dec-13	N/A	0	250,000.00	5.9975	$1,499,375.00		$44,831.35
	C	Dec-13	Call	6.5	518,800.17	5.9975	$3,111,504.00		$93,345.12
	B	Dec-13	Put	5.5	−164,379.00	5.9975	$(985,863.08)		$29,575.89
	D	Dec-13	N/A	0	−750,000.00	5.9975	$(4,498, 125.00)		$134,943.75
	E	Dec-13	Put	5.5	164,383.79	5.9975	$985,891.79		$29,576.75
	F	Mar-13	Put	6.91	59,761.61	5.9975	$358,420.27		$10,752.61
	G	Mar-13	Call	6.91	−65,198.86	5.9975	$(391,030.18)		$11,730.91
	I	Jul-13	Call	6.92	−67,119.50	5.9975	$(402,549.20)		$12,076.48
	H	Jul-13	Put	6.92	57,716.57	5.9975	$346,155.12		$10,384.65
Corn Total				**Net Total**	3,131.62	5.9975	$18,781.89	$2,817.28	$377,217.50

(ii) Standardized Approach offsetting exact same Commodity, Month, Strike, Put/Call—Same methodology used in Row 2 of the comment letter

Underlying Group	Positions included	Contract Month (MMM–YY)	Option Type	Strike	Delta	Spot Price	Delta Notional	15% Net Charge	3% Gross Charge
Corn									
	F	Mar-13	Put	6.91	59,761.61	5.9975	$358,420.27		$10,752.61
	G		Call	6.91	−65,198.86	5.9975	$(391,030.18)		$11,730.91
	H	Jul-13	Put	6.92	57,716.57	5.9975	$346,155.12		$10,384.65
	I		Call	6.92	−67,119.50	5.9975	$(402,549.20)		$12,076.48
	A, D	Dec-13	N/A	0	−500,833.15	5.9975	$(3,003,746.82)		$90,112.40
	B		Put	5.5	4.79	5.9975	$28.71		$0.86
	C		Call	6.5	518,800.17	5.9975	$3,111,504.00		$93,345.12
Corn Total				**Net Total**	3,131.62	5.9975	$18,781.89	$2,817.28	$228,403.03

(iii) Standardized Approach offsetting within same commodity and expiry—Same methodology used in Row 3 of the comment letter

Underlying Group	Positions included	Contract Month (MMM–YY)			Delta	Spot Price	Delta Notional	15% Net Charge	3% Gross Charge
Corn									
	F, G	Mar-13			−5,437.25	5.9975	$(32,609.91)		$978.30
	H, I	Jul-13			−9,402.93	5.9975	$(56,394.09)		$1,691.82
	A, B, C, D, E	Dec-13			17,971.80	5.9975	$107,785.89		$3,233.58
Corn Total				**Net Total**	3,131.62	5.9975	$18,781.89	$2,817.28	$5,903.70

The CHAIRMAN. Thank you.

Mr. Peterson.

STATEMENT OF HOWARD W. PETERSON, JR., PRESIDENT AND OWNER, PETERSON OIL SERVICE, WORCESTER, MA; ON BEHALF OF NEW ENGLAND FUEL INSTITUTE; AMERICANS FOR FINANCIAL REFORM; AMERICAN FEED ASSOCIATION; INDUSTRIAL ENERGY CONSUMERS OF AMERICA; GASOLINE; AUTOMOTIVE SERVICE DEALERS; TRUCKING AND AIRLINE ASSOCIATION *

Mr. PETERSON. Chairman Scott, Ranking Member Scott, and Members of the Committee, as the Owner and President of a small Main Street business, I thank you for the opportunity to provide my perspective on the CFTC reauthorization.

My company, Peterson Oil Service, is a fourth generation, family-owned and operated business that has served the home heating needs of central Massachusetts since 1946. Our company sells BioHeat® Fuel, a blend of biodiesel and low sulfur heating oil produced by local biodiesel manufacturing plants and waste vegetable oil. This blend burns cleaner and more efficiently, and has a lower carbon footprint than natural gas.

I am testifying as past Chairman of New England Fuel Institute, and as the Director of the Petroleum Marketers Association of America. Together, these associations represent marketers who serve more than eight million BioHeat® fueled households in home, industry—to over 100,000 convenience stores and gasoline stations. These businesses, including my own, rely on functional commodity futures, options and swap markets as a hedging and price discovery tool in order to minimize the exposure to price volatility, and to provide our customers with the most affordable products possible.

We urge the Congress to fully fund the CFTC at the amount requested for Fiscal Year 2016. The importance of funding the CFTC cannot be overstated, especially given its mission to protect businesses like mine from fraud, manipulation, and wild price swings that can result from excessive speculation and disruptive trading practices.

The CFTC is the cop on the beat, and needs adequate resources to oversee constantly these evolving markets. In the 4 years leading up to the passage of Dodd-Frank, this Committee and others in Congress held countless hearings on the causes of the 2008 crisis that created unprecedented volatility in energy and other commodities. During these hearings, businesses like mine joined in bipartisan support with other industries, and called upon Congress to bring greater transparency, accountability and oversight to the commodity markets. Since then, these markets have become even larger, and the need for oversight is even greater.

Congress did three important things. First, through Dodd-Frank, it improved the transparency and market oversight to further protect end-users against fraud and manipulation. Second, Congress strengthened the CFTC's ability to police and prosecute market manipulation. Penalties imposed by the CFTC have increased from

* This organization endorses only the testimony on position limits.

$100 million in 2009, to $1.8 billion in 2014. Last, Congress required the CFTC to impose speculative position limits on all commodities in futures and swaps markets. It did so to reinforce the ability of hedgers like me to effectively manage commodity price risks.

Despite having missed the deadline set by Congress, the Commission has continued to work on a final position limits rule, however, there has been talk of ceding the CFTC's authority to set position limits and define hedge exemptions to the exchanges. NEFI and PMAA oppose this proposal. The exchanges are publicly traded entities that have a profit motive favoring higher trader volumes and a larger number of market participants. As such, they would have a bias towards higher limits and broader exemptions.

We hope the Committee will once again include language to enhance protections of regulatory relief for end-users. During the MF Global crisis, for example, several of my peers became victims when their accounts were frozen. It is important that Congress expand and protect companies like these. We also applaud you for reinforcing the need to keep small hedgers from being caught in the net by regulations meant for larger market participants. The Committee should also take a zero tolerance approach to fraud and manipulation. Current civil penalties are inadequate to deter such actions, especially when compared to the overall profits of large market participants who view them simply as the cost of doing business. Congress should increase these penalties.

As we move forward in the process, we caution you against inadvertently creating new loopholes that might benefit financial institutions and other large market participants. These include overly broad exemptions meant only for *bona fide* hedges. We oppose Congressional intervention in the CFTC's negotiations with its overseas counterparts regarding the harmonization of cross-border regulation of derivatives. Large traders should not be allowed to evade U.S. oversight by trading through offshore affiliates. We also caution against dramatically expanding the CFTC's cost-benefit requirements. This will result in more litigation, not less, and delay important new rules meant to protect small hedgers.

Thank you again for the opportunity to testify, and I would be happy to answer any questions you may have.

I know my time is up, but I might ask for the following groups to be added to the record as endorsing my testimony. The Americans for Financial Reform, the American Feed Association, the Industrial Energy Consumers of America, the Gasoline and Automotive Service Dealers, and on position limits, the Trucking and Airline Association.

Thank you for your time.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HOWARD W. PETERSON, JR., OWNER AND PRESIDENT, PETERSON'S OIL SERVICE, WORCESTER, MA; ON BEHALF OF NEW ENGLAND FUEL INSTITUTE; AMERICANS FOR FINANCIAL REFORM; AMERICAN FEED ASSOCIATION; INDUSTRIAL ENERGY CONSUMERS OF AMERICA; GASOLINE; AUTOMOTIVE SERVICE DEALERS; TRUCKING AND AIRLINE ASSOCIATION *

Chairman Austin Scott, Ranking Member David Scott, and Members of the Committee, thank you for the opportunity to testify before you today. My name is Howard Peterson and I am Owner and President of Peterson's Oil Service of Worcester, Massachusetts. I am an "end-user" or more appropriately, a *bona fide* hedger, of energy commodities. I look forward to providing the Committee with my perspective on the Commodity Future Trading Commission (CFTC) and its forthcoming reauthorization.

Introduction

Peterson's Oil Service is a fourth generation family-owned and operated company that has served the home heating needs of central Massachusetts since 1946. Our company sells BioHeat® Fuel, a blend of biodiesel and low sulfur heating oil. BioHeat has been shown to be the cleanest burning and most efficient home heating fuel on the market.[1] We purchase biodiesel that has been produced from waste vegetable oil by locally-owned and operated biodiesel manufacturing plants. We also provide a variety of other home energy services such as Heating, Ventilation and Air Conditioning (HVAC) system maintenance and repair, and market gasoline and other motor fuels. Peterson's Oil Service is a small business with little more than 80 employees. We are invested in and active members of the communities we serve and are personally acquainted with many of the customers. We hope the Committee will benefit from the perspective of our company as it is a true "Main Street" end-user of commodity derivatives.

I am also testifying on behalf of the New England Fuel Institute (NEFI). Peterson's Oil Service is a long-time member of NEFI and I served as its Chairman for 4 years (2010–2014). NEFI has been a leading voice and advocate for the home heating industry for more than 70 years, representing the industry on a variety of state, regional, and national public policy issues. Nationwide, approximately 8,000 home heating oil and BioHeat® retailers serve more than eight million households and employ over 50,000 people. Many of these retailers also market other heating fuels such as kerosene, propane and coal, and most offer a variety of home energy solutions designed to cut heating and cooling costs, including energy audits, efficiency upgrades and weatherization services.

In 2007, NEFI formed the Commodity Markets Oversight Coalition (CMOC), a diverse and nonpartisan alliance of consumer, business and industry groups in the energy, transportation and agricultural sectors concerned with opacity in the commodity derivatives markets. This includes airlines, trucking companies, utilities, industrial manufacturers, food processors, farmers, and ranchers. CMOC members successfully advocated for many of the reforms included in the last reauthorization of the CFTC and, more recently, in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Like many in our coalition, my business relies on functional commodity futures, options and swaps markets as a hedging and price discovery tool. Peterson's Oil Service has long deployed a hedging program to insulate our business from volatility associated with the price of crude oil and refined petroleum products and to provide our customers with the most affordable product possible. Many home heating fuel dealers either hedge directly, or enlist the assistance of a broker, futures merchant or swaps dealer, in order to minimize their exposure to price volatility. Hedging programs are especially important for retailers that offer fixed price or prepay agreements to their customers, wherein a customer can lock-in a price for their fuel prior to the start of the heating season. Hedging affords our customers downside protection in the event that prices moves unexpectedly when the physical delivery is made in the winter time.

In order for our industry to hedge with confidence, security and protection from manipulation, a fully authorized and funded CFTC is essential. As such, let me begin by commending this Committee on its efforts to reauthorize the CFTC and urge the Congress to fully fund the agency at the $322 million level as requested for Fiscal Year 2016. The importance of fully funding the CFTC cannot be over-

* This organization endorses only the testimony on position limits.

[1] *Natural Gas Expansion Study: A Stakeholder Response,* Prepared by Exergy Partners Corp. for the Massachusetts Energy Marketers Association, Submitted to the Massachusetts Department of Energy Resources (DOER), December 18, 2013.

stated, especially given the mission it has been tasked with by Congress: that is, to protect businesses like mine from fraud, manipulation and wild price swings that can result from excessive speculation and disruptive trading practices. The CFTC must do all of this despite its limited resources, an unprecedented expansion of its responsibilities under the Dodd-Frank Act, constantly evolving markets, and ever-changing trading practices and technologies. CFTC Chairman Massad and Commissioners Wetjen, Bowen and Giancarlo should be commended for their commitment to transparent, accountable and functional markets that serve the needs of small hedgers like me. They are the cops on the beat and need proper resources to be successful. It is important that Congress continue to provide the Commission with the resources it needs and the authorities necessary to get the job done.

Perspectives on Dodd-Frank

Through Title VII reforms in the Dodd-Frank Act, Congress sought to address the root causes of the 2008 financial crisis—but this was not the only crisis that Congress sought to address. Many of the Title VII reforms also sought to address a crisis of opacity, instability and diminished confidence in the derivatives markets following an historic bubble in commodity prices. In the 4 years leading up to the passage of Dodd-Frank, this Committee and others in Congress held countless hearings on the causes of this bubble and unprecedented volatility in energy and other commodities. During these hearings, business groups like ours joined with other like-minded industries and called upon Congress to bring greater transparency, accountability and oversight to the commodity derivatives markets. Since the crisis in 2008, these derivative markets have become even larger and need for oversight even greater.

In response to these requests from end-users of derivatives and other commodity-dependent businesses, Congress did three important things. First, in an attempt to improve price transparency and market surveillance and to further protect end-users against fraud and manipulation, it expanded CFTC jurisdiction to the $700 trillion (notional value) over-the-counter swaps markets.[2] Swap dealer registration, data collection, price transparency, and central clearing helps to promote greater competition in these markets and is necessary in order to hold parties responsible for violations of the Act. Prior to the enactment of Dodd-Frank, these markets were almost entirely opaque and on several occasions had given cause to alleged or proven cases of market manipulation.[3]

Second, Congress also strengthened the CFTC's ability to prosecute instances of manipulation and attempted manipulation, including expanded authority to prevent disruptive trading practices and the inclusion of Senator Cantwell's "Anti-manipulation Amendment." The Cantwell Amendment provided the CFTC with new authority to more effectively prosecute and deter manipulation by changing the burden of proof from "specific intent" to the same fraud-based "reckless conduct" standard employed by the Securities & Exchange Commission (SEC) and other financial regulators. The effects of these measures to bolster the policing and prosecution of fraud and manipulation are clear. Since 2009, penalties imposed by the CFTC have increased from $100 million in Fiscal Year 2009 to $1.8 billion in Fiscal Year 2014.[4]

Last, Congress included in Dodd-Frank a requirement that the CFTC impose speculative position limits across all commodities in the futures and swaps markets. This includes energy futures and OTC energy and agricultural swaps which had been exempt from such limits since the enactment of the Commodity Futures Modernization Act of 2000. The "position limits mandate" was included in response to concerns raised by NEFI, its coalition allies and other *bona fide* hedgers that excessive speculation was harming price discovery and their ability to effectively manage commodity price risks. Congress included the mandate as a prophylactic measure to help prevent a repeat of the 2007–2008 commodity market bubble, to minimize wild price swings and extreme market volatility, and to prevent market manipulation.

It is also important to note that this rule was included with broad bipartisan support. In fact, as far back as the 110th Congress, a stand-alone bill that would have mandated the imposition of speculation limits was passed with broad bipartisan support. The bill, known as the Commodity Markets Transparency and Account-

[2] Source: Testimony of CFTC Commissioner Timothy Massad before the U.S. House of Representatives, Committee on Appropriations, February 11, 2015.

[3] Examples of energy market manipulation or alleged manipulation include the copper markets (Bankers Trust, 1996), natural gas (Amaranth, 2006), Propane (BP North America, 2007), crude oil (Parnon Energy, *et al.*, 2008), gasoline and heating oil (Optiver Holding BV, 2007) and electricity (JP Morgan, 2010–2012).

[4] Source: Written Testimony of CFTC Commissioner Timothy Massad before the U.S. House of Representatives, Committee on Appropriations, February 11, 2015.

ability Act of 2008, passed with the support of 69 Republicans. Several of those Republicans remain in Congress and are Members of this Committee, including past Chairman Frank Lucas of Oklahoma and current Vice Chairman Bob Goodlatte of Virginia.

Congress had required that the CFTC promulgate a position limits rule by mid-January 2011. Four years have now passed and the CFTC has still not finalized a rule. A revised rule was proposed in December of 2013 that addresses the concerns of the court and that seeks additional input from *bona fide* hedgers on the proper structure of the hedge exemption. This is the third position limits rule to be considered by the CFTC since January, 2009. Over the last fifteen months the current proposal has been opened up to public comments at least four times. Most recently the CFTC has opened up the rule to comments following a meeting of the Energy & Environmental Markets Advisory Committee (EEMAC) on February 26th with comments due on Saturday, March 28th.

NEFI is concerned with a suggestion made at the recent EEMAC meeting that the Commission cede to the exchanges its authority to set speculative position limits and issue *bona fide* hedge exemptions. Commodity exchanges are not regulatory agencies tasked with protecting the public interest. They are publically-traded, for-profit entities. As such, they benefit from higher trading volumes and a large number of market participants. Therefore the exchanges have a profit motive to make positon limits voluntary or unreasonably high, and to institute broad hedge exemptions that may include non-commercial market participants (such as financial speculators). NEFI strongly opposes these suggestions. They clearly run contrary to the intent of Congress, which is that the CFTC—not the exchanges or self-regulatory organizations—should be tasked with the responsibility to set position limit levels and define who should be eligible for *bona fide* hedge exemptions. Congress should watch developments closely and take action as necessary to ensure that this intent is preserved.

Recommendations for Reauthorization

Again, we commend Chairmen Scott and Conway and Ranking Members Scott and Peterson their commitment to moving forward with CFTC reauthorization. We further commend the Committee for its interest in giving the CFTC the necessary authority to preserve market integrity and to protect small hedgers like myself from fraud and manipulation or from inadvertently being "caught in the net" by CFTC rules and regulations meant for financial firms and large commercial entities. The reauthorization process also provides an opportunity to correct imperfections either in Dodd-Frank reforms themselves or in their implementation. In order to better serve *bona fide* hedgers and businesses like mine, we urge Congress to:

- *Provide Greater Protections for Customer Funds.* The Committee should most certainly include the same robust customer protections found in Title I of H.R.4413 last year. While my company was not directly affected, several of my peers in the heating oil industry were victims of the collapse of MF Global. Their accounts were frozen and in some cases their market positions were jeopardized. If the effect of the crisis were more widespread it could have had a dramatic impact on my industry and the ability of some companies to serve their customers. Congress, CFTC and the exchanges should be commended for their efforts to strengthen consumer protections and prevent a repeat of "MF Global."
- *Reinforce Congressional Intent Regarding End-users.* In enacting the Dodd-Frank Act, Congress did not intend for many of its rules and regulations to adversely impact *bona fide* end-users of commodity derivatives, including businesses like mine. Therefore, we commend this Committee for reinforcing end-user protections in Title III of H.R. 4413 last year. However, NEFI and its coalition allies would like to caution this Committee against inadvertently creating new loopholes or regulatory exclusions that might benefit financial institutions and other large market participants by weakening exemptions meant only for *bona fide* commercial hedgers.
- *Prevent Cross-Border Regulatory Arbitrage.* We also caution the Committee against intervening in CFTC negotiations with its overseas counterparts regarding the harmonization of cross-border regulation of derivatives transactions. Systemically significant market participants, especially large financial institutions, should not be allowed to evade U.S. oversight and regulation by trading through off-shore branches, subsidiaries and affiliates. As we learned from the 2008 financial crisis and the LIBOR scandal, the Amaranth case and other instances of market manipulation, cross-border derivatives transactions can have significant consequences for American businesses and consumers and the broader U.S. economy.

- *Expand the Study into High-Frequency Trading.* The Committee was wise to include a study into High-frequency Trading in H.R. 4413 last year, however this study should be expanded. Congress should require a broad inquiry into the role of new trading technologies and practices that utilize complex algorithms and conduct automated trading, and the development new transmission technologies.[5] It should also examine the cyber-security and national security implications of such technologies and activities, their impact on market volatility, and whether or not they could (intentionally or unintentionally) disrupt or manipulate futures and swaps markets.
- *Increase Penalties for Fraud and Manipulation.* The previous reauthorization in 2008 strengthened antifraud provisions and increased civil monetary penalties for manipulation from $500,000 to $1 million per violation. As a matter of course, these penalties have become insignificant when compared to the overall profits of large market participants and have become part of the "cost of doing business." The Committee should take a "zero tolerance" approach to such behavior. We urge you to include in reauthorization an increase in fines and penalties for fraud, manipulation and other severe violations of the law, and include jail time as appropriate in order to further deter such acts.
- *Remove Expanded Cost-benefit Requirements.* As a heavily regulated business I understand and appreciate the importance of thoroughly weighing potential costs and benefits of any Federal rule or regulation. However, unlike many Federal agencies, the CFTC is already subject to robust cost-benefit requirements. In many of its final rulemakings, the Commission "quantified a variety of costs, considered alternative approaches, sought to mitigate costs and responded to significant comments" and in one instance the quantification of costs ran on for 24 pages in the *Federal Register.*[6] Furthermore, costs and benefits with respect to certain financial regulations can be difficult to quantify, especially in the case of prophylactic regulations such as the position limits rule. The dramatic expansion of cost-benefit requirements proposed under Section 203 of H.R. 4413 last year would establish unreasonable hurdles for the CFTC to overcome, including a requirement that the CFTC analyze abstract and theoretical cost impacts and that it list all of the ambiguously defined "alternatives." This could lead to *more* litigation, *not less,* and result in the significant and unwarranted delay of many new rules, including those meant to protect small hedgers.

Conclusion

We commend the Committee for holding hearings to solicit the input of *bona fide* hedgers and other market stakeholders before it moves forward with CFTC reauthorization. Congress should not miss this opportunity to expand protections for small hedgers and strengthen prohibitions against fraud and manipulation. Markets function best when they are fair, transparent, competitive and accountable; and the commodity derivatives markets are no exception. Thank you again for the opportunity to appear before you today. I would be happy to answer any questions you might have and our industry would be happy to provide further input to the Committee as things progress.

The CHAIRMAN. Thank you, Mr. Peterson, and without objection, we will be happy to add that to your written testimony for you as you requested.

They haven't called votes yet so we are going to go ahead with the questions. And I will yield myself 5 minutes.

And as many of you outlined in your testimony the real costs that are being incurred by end-users in complying with the Dodd-Frank Act rules. Can you be more specific with the sort of measures that you and your organizations have had to undertake to address the new rules, and whether or not you think that the cost and benefit is reasonable?

Mr. CHRISTIE. I will take a stab at that. I think when you talk about costs or regulations, there are really two elements of costs. One is the direct cost of compliance, and in our case as a cash user,

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[5] Examples include fiber optic, wireless and microwave- and satellite-based transmissions.

[6] Berkovtiz, Dan M., "Swaps Provisions of Dodd-Frank Act: Cost-Benefit Analysis and Judicial Review," *Banking & Financial Services,* September 2014, Page 8.

one of those is technology and resources to capture and retain records to meet reporting requirements. That is a fixed and known cost. The cost that is less quantifiable is the secondary cost of the cost of risk throughout the system, and if we don't have access to the current commercial risk management practices that we have utilized, costs go up and those get passed throughout the system. And in some cases, it could result even in loss of liquidity in markets, and less price signal. So there is both a direct and an indirect cost to an environmental regulation around position limits particularly.

Ms. CAVALLARI. I would just build on that, if I could.

The CHAIRMAN. Yes, ma'am.

Ms. CAVALLARI. Thank you, Mr. Chairman. The implicit and explicit costs are also very visible to pension plans as well as an end-user, similarly. In my testimony, I talked about costs being raised explicitly by over 20 times by an FCM that our pension plan faces. So we are starting to see the direct cost. The implicit cost is going back and revising investment management agreements, getting internal and legal external counsel to sign off on revised documentation, and new documentation for new specific terms that have never been in the marketplace before, as well as concepts in terms of representations that are needed from clients, and new ways of trading swap execution facilities were not in existence before. So those are just a few of some of the direct and indirect costs. Thank you.

The CHAIRMAN. All right, thank you.

Mr. Christie, if the CFTC significantly narrows the scope of *bona fide* hedging exemptions for position limits, will that impact your ability to serve cotton producers, and how would it impact commodity users generally?

Mr. CHRISTIE. Sure. I can give you a cotton example, and then other examples as well. But in the cotton industry, it is very common for a commercial firm to make a commitment to buy all of the production that would come off of fixed acreage. That is particularly common in Texas. That production is highly variable based on weather. So a single weather event, a timely rain or an untimely hailstorm could have a positive or negative impact on production.

A commercial user like us needs to be able to reflect our real-time perceptions of that production and the obligation to buy that production by having active hedges. And a narrow definition of *bona fide hedges,* we would only be able to count as *bona fide* a hedge once a final volume was known, and that is really too late to pass the right price signals to producers. That is an example of a fixed commitment in the cotton business, but it could be in irrevocable bid or offer in a grain market. I am sure there are examples in the energy markets as well where we have a clear risk obligation that we need to hedge with traditional mechanisms that we have used in the past.

The CHAIRMAN. Okay. Thank you.

Mr. Campbell, what would the consequences for energy markets be if the CFTC significantly lowered the swap dealer *de minimis* threshold from the current $8 billion to $3 billion?

Mr. CAMPBELL. Thank you, Mr. Chairman. I brought it up in my testimony, and we have a case study that we saw with regard to

special entities in the lower limit—of the lower threshold that applied to them. And people made the conscious choice not to transact and swap with these entities because they did not want to trigger the swap dealer threshold. These entities were dramatically impacted by that. They did not have a market, a market that they usually relied on with entities like ours that were counterparties with them in the physical space, were no longer willing to transact with them in the financial space to help them hedge. And they were left with basically, essentially, the large banks, the very large registered dealers to transact with, and ultimately, they sought relief from the CFTC.

The CHAIRMAN. Thank you.

I am going to yield the remainder of my time back. And I would like to recognize now my colleague, Congressman Scott from Georgia. And after his questions, we will break for votes, and then we will come back as soon as the votes are over with.

Mr. DAVID SCOTT of Georgia. Yes. Let me ask you. As I mentioned in my opening statement, I am very concerned about keeping the continuity of H.R. 4413. I think that that is a path we need to keep on. And in our bill last year, we did something very important for you. We eased some reporting requirements for our end-users, and I believe that it was critical that we do so in order to relieve some practices that were very burdensome on you all.

So for each of you, could you tell me what were your recordkeeping practices before Dodd-Frank, and how have they changed since?

Mr. CHRISTIE. I can give a couple of examples. We always place a high premium on compliance, and we will keep the records that are required to meet those obligations. An example in our business as times have evolved, more and more of our business gets transacted or communicated via e-mail, via text message, and not just on hardline phones that come into our office. So a requirement to keep records on cash transactions that may ultimately lead to a derivative transaction, capturing all of the methods and the modes in which that might come in has been a challenge. And our response to that has been to, in some ways, narrow the access or limit the kinds of transactions that we will accept in order to be compliant with recordkeeping requirements.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. CHRISTIE. And we think that is detrimental to the interests of the users that we are serving.

Mr. DAVID SCOTT of Georgia. Yes. One of the concerns I had was the unfortunate financial burden that some of this had on you. So give me an example, what are your monthly expenses associated with these recordkeeping requirements?

Mr. CHRISTIE. I think that is a good question. I don't have access today to tell you what our monthly costs would be, but that is certainly information that we could provide to you.

Mr. DAVID SCOTT of Georgia. Does any of you—would any of you have access to that? That would be very helpful in us keeping some of these regulatory burdens off of you if we did have some actual factual implications of the degree of financial burden, and how beneficial what we were doing were to you. Is there anyone——

Mr. MAURER. I could——

Mr. DAVID SCOTT of Georgia. Yes, Mr. Maurer. Yes.

Mr. MAURER. I could speak for the, we are not an end-user, but most of our—all of our customers are end-users, but in terms of the monthly cost, we have to report all of our over-the-counter trades to the DTCC on a monthly basis. And annualized it is, I want to say, right around $600,000, not including the programming, not including the staff, just the fees that we have to pay.

Mr. DAVID SCOTT of Georgia. You said $600,000?

Mr. MAURER. Yes, that is not including the people, the programming, just the fees associated with reporting those trades.

Mr. DAVID SCOTT of Georgia. Okay. Yes, Mr. Campbell?

Mr. CAMPBELL. Sure. The great example on the EEI side is physical options. I mean these are physical products that were never considered swaps in the first place. So after Dodd-Frank, we were required to—industry was required to treat these things and track these things and record these things as if they were swaps. Although the CFTC did provide some relief, we still had to set up new systems to identify these things as swaps to track all exercises of these options. So even though there is relief from reporting to some degree, there are still additional systems and build-out that needs to be done to meet the obligations, even under the relief.

EEI did a poll, in general, most companies had to hire additional employees and staff to meet these obligations, and develop systems. I know my company spent a significant amount of money developing systems to do all the new tracking that it had to do. And I believe EEI does have a number and we can get that to you later on. But that is just one example.

And to my point in my testimony, we still don't see the offsetting public benefit of regulating physical transactions——

Mr. DAVID SCOTT of Georgia. Yes.

Mr. CAMPBELL.—like they are financial products.

Mr. DAVID SCOTT of Georgia. So for all of you, what we did in H.R. 4413 is what we should continue to do in the new legislation. It was helpful to you in relieving some of that burden, is that correct?

Mr. CAMPBELL. I would say absolutely, yes.

Mr. DAVID SCOTT of Georgia. All right, thank you, sir.

The CHAIRMAN. All right, vote has been called. We should be back in approximately 30 minutes. I would just ask that we all return as quickly as possible. And this hearing will stand in recess, subject to the call of the chair.

[Recess.]

The CHAIRMAN. We'll try to start about 35 after, but as a courtesy, I'm trying to wait until there is a representative of the minority party.

All right, we will call the meeting back to order.

And Mr. LaMalfa would be next. Mr. LaMalfa, the floor is yours for 5 minutes.

Mr. LAMALFA. Okay, thank you, Mr. Chairman.

To Mr. Maurer, thanks for your patience in us doing our thing over there. Earlier in your testimony, you mentioned that with CFTC, the cross-border guidance proved to be much more complex than what we need. We are all concerned that some of these requirements impose a burden that is much greater than any pos-

sible benefit for U.S. markets, and so the uncertainty remains over how to apply this directive in terms of the personnel that are overseas, and the U.S. personnel of foreign entities in trading swaps. Your support for recognition of non-U.S. regulators interests in regulating their own markets. Can you elaborate a little bit more on that please?

Mr. MAURER. Sure thing. Thank you, Congressman.

The issue I see there, I was in London last week, and we were sitting around a table and talking about how can we grow the business, and we have a significant amount of our customers that don't want to go through the rigmarole and the necessary paperwork, and all of the regulations that come from Dodd-Frank. And we are trying to, and that is our issue to deal with, we recognize that, and we have to get those customers comfortable. But——

Mr. LAMALFA. But some of you on the panel, just with Mr.——

Mr. MAURER. Yes.

Mr. LAMALFA.—Mr. Scott, before our break, you were talking about how that basically have people not willing to write certain types of swaps or deals, at least at a lower level, that there has to be a pretty high bar of value to make it worth the trouble. Does that kind of dovetail with that then?

Mr. MAURER. Well, there has to be a commercial reason why we do the business, for sure.

Mr. LAMALFA. Yes.

Mr. MAURER. And——

Mr. LAMALFA. But let us raise the bar to make it commercially viable, right? It has to be a bigger transaction to make it worth all the paperwork trouble, yes?

Mr. MAURER. Well, our business model is, no matter the size of the trade, we are wanting to help out the end-user. But I see your point and it is noted, but we have many customers that we do trades at a loss for because we are here to help out the customer. I understand your point there. And we are seeing even in some of our competition also taking their—they may or may not be a swap dealer, but taking their business and those jobs and that staffing outside of the United States, so they do not have to deal with Dodd-Frank. And, we obviously are not doing that, we are here.

And if you look back, I would say, a couple of years when Dodd-Frank was first being implemented, you saw a rather noticeable decline in the amount of over-the-counter business, and what you are seeing now is we are seeing our domestic business starting to pick back up. And I believe that that is partly cyclical, but also because our customers and our end-users, once again, the farmers of America are realizing there is a lot of value added when doing over-the-counter-type hedging, and they are coming back and they are saying maybe the paperwork, yes, it is labor-intensive, and yes, it is almost intimidating, but——

Mr. LAMALFA. Yes.

Mr. MAURER.—it is worth it to get the value-added services that we offer.

Mr. LAMALFA. Good. Thank you.

I am about out of time. Mr. Campbell, I appreciate your comments on how it applies to energy. Of course, we carried the bill my last term here on how municipal utilities were affected nega-

tively by Dodd-Frank by having to be considered swap dealers at that low threshold, and of course, this shows that this—changes can be made in Dodd-Frank, at least on a subtle level. We were successful on a bill getting out to the House, for 23 to 0, that the CFTC later adopted those regs. And so I am glad we could move the ball in that area here. So we as a Committee certainly need to understand or know of certain areas we can tweak to continue to have more opportunities for swaps to be made and not have this regulatory burden to artificially stop them and chill the market.

So with that, I will yield back my time. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Scott?

Mr. DAVID SCOTT of Georgia. Thank you.

One of the areas that I have been especially concerned about is, in order for everything that we actually have done to help you, and to put into H.R. 4413, requires the CFTC to do an effective job. Each of you are stakeholders in this, with the most direct exposure to how well the CFTC does its work, do you feel the CFTC is adequately funded? Yes, any of you can answer that. I think it is good to get a feel from you, if you all think it is adequately funded or not.

Mr. CHRISTIE. Yes, it is obviously difficult to set an absolute level of what funding should be, but one comment I would make on that is that historically, when we have looked at regulatory issues or position limits in particular, it has been more of a collaborative relationship between the CFTC, market participants, the exchanges, and even industry associations——

Mr. DAVID SCOTT of Georgia. Yes.

Mr. CHRISTIE.—involved in that process. And that brought some efficiency and some clarity to that process that a lot recordkeeping maybe doesn't necessarily do as effective a job as having a more of a conversational approach. To the extent that it is driven by recordkeeping and reporting, that may carry a cost burden that is higher than when it is more collaborative and more shared across all market participants.

Mr. DAVID SCOTT of Georgia. Yes, but are there any of you here that feel it is not adequately funded, and needs to have effective funding to do the job that we are asking them to do?

Ms. CAVALLARI. Yes.

Mr. DAVID SCOTT of Georgia. Yes, Ms. Cavallari.

Ms. CAVALLARI. Yes, it is critically important that as we are moving towards implementation, that we have shifted from regulation and rules being promulgated by the CFTC, and certainly the CFTC is a global leader in that——

Mr. DAVID SCOTT of Georgia. Yes.

Ms. CAVALLARI.—in that construct in terms of tapping these markets when other regulators are not as far along in their rulemaking. As we shift towards that implementation, that is where some of these issues are vitally important in terms of getting it right. So it really reemphasizes the importance of that, of the CFTC, in that process.

Mr. DAVID SCOTT of Georgia. And so how important do you all think it would be for us to ask the CFTC, in other words, to allow

for a delay in real-time swap reporting for non-financial end-users whose swap activities can be identifiable in thinly-traded markets in order to prevent them from being competitively disadvantaged by the financial players? How important is that? See, what I am trying to get at here is the fact that, while we have you here, I just think it is important because it is the CFTC that has to carry all of this out, and my concern is that I feel, quite honestly, that all that we are asking it to do, its workload has tripled, I just want to get a feel from those of you who are impacted by the work of the CFTC if we are giving them enough funding, if they have enough staff. I think we have to look at that with a very serious jaundiced eye as we move forward, especially for you all. You are the ones, not me, but you are the ones that sort of have to say, "Hey, they may need to pick the wicket up here or do what they should be doing in a better way."

Mr. MAURER. I will agree with what Mr. Christie said earlier. When you involve the end-user and the market participants and get the voices of who the rules are actually affecting, it creates a more efficient environment, and hopefully one where the CFTC can make do with their current budgeting. But I can't speak to the CFTC's budget, but I do agree with Mr. Christie.

Mr. DAVID SCOTT of Georgia. Well, let me ask you this, and I will be thorough on it. Are there any areas, in your opinion, of the Commission's work that you feel need more support? Is there anything they are doing that affects you and which you think we need to address that they could do better? I mean you have a chance here to say something about them, but——

Mr. CHRISTIE. Yes.

Mr. DAVID SCOTT of Georgia.—their feelings are not going to be hurt. It would help us to either continue to fight for them to get more or not. But if you all are happy, is there any area in which you feel they need more support or can do better? Yes, Ms. Cavallari?

Ms. CAVALLARI. Again, when it comes back to the implementation of these particular regulations, the CFTC is critically important in terms of how we go forward, and the intersection of so many rules, not just that the CFTC makes, but that has been emphasized in terms of cross-border, these—we need to keep liquid markets and those market participants active. And each one of us at the—this table actually represents a different end-user, and I realize it is more of a philosophical statement, but I truly believe that we need to preserve, and the CFTC can help this, the liquidity of these marketplaces.

Mr. DAVID SCOTT of Georgia. Okay, well, thank you. But I guess we could say all of you feel, in conclusion, that the CFTC is doing a good job and has sufficient funding. Thank you, sir.

Mr. MAURER. If I——

Mr. DAVID SCOTT of Georgia. Pretty much?

The CHAIRMAN. Mr. Maurer, you can answer, but then we are going to have to move to the next Member.

Mr. MAURER. Okay. The CFTC could be doing a better job of getting the end-user and getting the people that are affected by the rules into the rooms, and to get those people more involved with the decisions and more involved with the rulemakings so we can

make the whole process more efficient for everybody in the industry.

Mr. DAVID SCOTT of Georgia. Well, thank you. That helps us a lot.

The CHAIRMAN. Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman. It was nice somebody didn't care about hurting the CFTC's feelings today, so I appreciated your comments, the honesty and openness is really what we want, Mr. Maurer, and thank you for your comments on my colleague, Mr. Scott's, question.

I want to thank the Chairman for calling this hearing today. It is important that we do hear from end-users of derivatives because as others on this Committee have stated, we know that end-users didn't cause the financial crisis. End-users, including many agribusiness leaders in my home State of Illinois, they use derivatives to manage risks that are not central to their commercial activities, and yet they continue to deal with significant obstacles because of the CFTC, regulations. that follow the passage of Dodd-Frank. So again, Mr. Chairman, thank you.

And I would like to start my questions with Mr. Christie. Can you describe for the Committee what type of financial resources it takes for an ag, co-op, or a warehouse to hedge its future purchase obligations in the futures market?

Mr. CHRISTIE. I can't comment on any specific firm what resources might be required, but to the extent that you have a wide breadth of tools to use, including exchange-traded instruments or swaps, if that is appropriate for the particular instance, that minimizes the resource requirement and it allows for customization for a particular situation. Both of those things are important for minimizing cost. There, obviously, are capital requirements if you want to compete or participate in an over-the-counter exchange, and that varies based on the size of the business. So I couldn't comment on any individual, but having access to a wide breadth of tools minimizes the costs overall.

Mr. DAVIS. All right, well, thank you.

Mr. Maurer, at a hearing before this same Committee in February, I expressed to Chairman Massad concerns I have with the position limits rule. Specifically, I expressed my concern with the so-called conditional limit proposal which would allow traders to hold positions in cash-settled contracts of up to five times the spot month limit, but only if they do not hold any positions in physical delivery contracts.

Can you explain how the conditional limit proposal would impact your business and the derivatives market in general?

Mr. MAURER. Thank you, Congressman. I would be happy to give you my opinions on those. Our firm specifically does very little business on the actual physical side and on the cash side. We are more financially based, at least the INTL FCStone Markets subsidiary, the company. I can give you my opinion on two areas in position limits if that would be okay?

Mr. DAVIS. That would be great.

Mr. MAURER. Okay. So I believe that the aggregation of position limits is one area that is affecting the company I work for, the parent company has multiple different subsidiary companies. We are

talking merchants, I won't go through all the names but they are all running separate, individual businesses. And if you have a customer that needs to belong, let us say 100 corn swaps—or 100 corn futures, pardon me, in one of these five subsidiaries, and then you have one in the other, and all of a sudden you are tying up the full limit at this point. As a company, we have to, at that point, pick which customer is more important, or which business line is more important because they are seen in aggregate. So what I would propose is that each business unit have their own limit. We are monitoring in that way now, it is preventing some of our customers to be able to do all their hedging.

And then the second hedging that is necessary—and then the second component would be the ability for the customers to—what is a hedge. Mr. Christie spoke on that earlier. I think that the definition of a *bona fide hedge* needs to be less complex, and needs to be more broad and give our end-users the ability to hedge their true needs. So——

Mr. DAVIS. All right, thank you.

Mr. Maurer, you mentioned the CFTC issues and what you thought they could do to possibly improve some of their interaction with end-users. I want to ask you a question about if there is a disagreement with the CFTC, are there any recommendations that you would have for this Committee for the administrative hearings process, for the adjudication process, or the conflict resolution process over a decision that the CFTC has? I have had different interactions about some frustrations that many end-users have with the CFTC in trying to resolve a problem, so can you give me your opinion on what they could do better?

Mr. MAURER. Well, you just hit it on the head there. I think that when we have those interactions with the CFTC, and when you are seeing a disagreement, the end-user needs to have a voice. And having panels like this gives them a voice, and there needs to be other avenues as well where we can reach out to our Representatives and make sure they are aware of the issues.

Mr. DAVIS. Thank you all very much for being here.

Mr. MAURER. Thank you.

The CHAIRMAN. Mr. Emmer.

Mr. EMMER. Thank you, Mr. Chairman. And I am going to—forgive me, Mr. Campbell, I am going to start with you—I am sorry, Mr. Peterson, because you are operating a business, and this is kind of a rhetorical question but it applies to everybody, and hopefully, it will make sense when I lead into the next ones.

Could you just explain briefly why regulatory certainty is so important from a business planning perspective?

Mr. PETERSON. I am a Main Street merchant, and my customers depend upon me in my hometown to deliver a commodity that is essential to their wellbeing. I deliver heating oil. And it is essential for them to—we just went through, in Massachusetts, we were in the national news, some very cold weather, some adverse situations, and our customers have a basic understanding that these basic commodities of life are going to end up on their doorstep in a timely manner, and that they are going to be treated fairly and priced fairly so that we do not have wild swings in price.

I am an end-user, and when I hedge, I have the expectation is that I do take final delivery, and I can't—there are very seldom, except in a few option series, but most cases, my hedging is entirely with physical delivery. So for me, price discovery and transparency of the transaction is paramount. And since Dodd-Frank and Title VII has come through, is that we have seen there has been more transparency in the aggregate, and more price discovery that makes me more comfortable with how I make presentations to my customers, who I see every day on Main Street.

I can't speak to some of the internal rules and regulations because most of my trading goes through a swap dealer, so they deal with the staff in Wall Street, but I look to take physical delivery.

Mr. EMMER. Fair enough. And, maybe it was inappropriate to pick on the business guy that is delivering the heating oil because, where I was going is, certainty is what the issue is for most businesses. You can adjust, but you need to be able to plan for the future, and these sudden changes make it very difficult.

Mr. Christie, I am going to ask you, has the CFTC's approach to rulemaking and the resulting rules caused you to restructure, reduce hedging, change your means of hedging, or trade less efficiently, and if it has, I ask this of Mr. Campbell and Ms. Cavallari as well, but if it has, can you explain how?

Mr. CHRISTIE. In the case of rule 1.35, we have made changes in our organization to limit the points and means of contacts that we have with the market in order to meet recordkeeping requirements on cash transactions that may lead to a derivatives transaction.

Our greater concern would be if CFTC were to go ahead with a narrow definition of *bona fide hedges,* that would have a very broad and very widespread impact on our commercial activities, and that would be of significantly greater scale than the changes that we have had to make so far around rule 1.35.

Mr. EMMER. Well, that is actually a question for—that I was going to say, but I can see I am going to run out of time.

Ms. Cavallari, Mr. Campbell, if you want to add to Mr. Christie's comments that would be great, but if you could all just address, in the time I have left, on this definition of a *bona fide hedge,* do you think Congress needs to be more explicit in defining what that is?

Mr. CAMPBELL. There is a definition in the Commodity Exchange Act that is pretty good. I think the issue that we are most concerned about from the end-user's side is the CFTC narrowing that definition even further, and really kind of picking away at practices that we have engaged in, sound risk-management practices, for years. So it is really more of a narrowing of the definition that Congress provides, as opposed to the definition itself.

Mr. EMMER. So it might be helpful if Congress would be more explicit with the definition so that it isn't narrowed?

Mr. CAMPBELL. Yes.

Mr. EMMER. All right. All right, and then I don't know if you had anything more to add on whether or not these other things have affected your ability to hedge, and you have had to restructure.

Ms. CAVALLARI. We have had to more closely examine the costs and what they are for the end-user in terms of the opportunity, whether we are looking at futures, cleared swaps, or bilateral swaps. So that component, the indirect cost, if you will, of regula-

tion has trickled down specifically into costs for the end-user. So because of that, we are more closely examining what specific instruments are appropriate for a pension plan to use.

Mr. EMMER. Thank you.

I see my time has expired. I yield back.

The CHAIRMAN. Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Thanks for holding this hearing. And I apologize, some of these questions may have already been asked but I didn't get to hear the answer. Mr. Christie, the Commission closed out its comments on the proposed position limits. And when I was back home last week, I heard from the cotton industry, specifically from the risk co-ops on the concern about being able to market and hedge the cotton farmer, the producers, as those producers put that cotton in the cooperatives. And the, of course, comes around the *bona fide* hedge. Can you kind of describe the problems that that could potentially create for those cooperatives, and how that might impact—the person I am most concerned about is that producer that has put his cotton with the cooperative and hoping that they are going to be able to use all the tools to get him the best return on his cotton that he can?

Mr. CHRISTIE. Thank you for the question. And, your district is an important one for us. We buy a lot of cotton out of that area, so I am happy to answer that question.

Particularly in west Texas, it is a dryland cotton production, it is very dependent on weather, and that can include favorable or unfavorable weather events. And in the case of a co-op, members are typically putting all of their production into that co-op, so it is important that the managers of that organization can consistently reflect their real-time view of how much production is going to be coming at them and be able to actively hedge that. If we had a very narrow definition of *bona fide hedges* where a fixed price needed to be attached to that cotton, or a fixed volume, that would limit the ability to make anticipatory hedges on that obligation. It is a very real concern that market participants have the ability to anticipate production and make hedges accordingly.

Mr. NEUGEBAUER. And are you concerned that the Commission's current position on that, or where you think they are headed, is going to be problematic for those cooperatives?

Mr. CHRISTIE. I think the risk or the concern would be that conditions change very dynamically, and so to have a single definition or a single line around what constituted a *bona fide* hedge, can be challenging because associated risk with that, it could be price risk, it could be delivery risk on forward commitments, there are a lot of things that could enter into the risk picture, and so letting people make economically-appropriate hedges that mitigate risk, it is important that they have that degree of freedom to do that.

Mr. NEUGEBAUER. So here is just a general question, because one of the concerns I have about when we start down the road of position limits and so forth is making sure that we have an appropriate amount of liquidity in the marketplace, and when you start beginning to say you can play, and you can't play, then I worry about that. Would—just in a general—Mr. Campbell, would you like to reflect on that?

Mr. CAMPBELL. Yes, and thank you. Because, loss of liquidity in the markets not only impacts your ability to access markets to hedge, but there is a lot of value in the futures markets for transparency. We use the futures markets for the price signal we get to price the contracts we enter into in the physical space. So if you have less liquidity and wider bid of spreads, it gets really difficult to price contracts in the physical space. So it can certainly impact all aspects of business, not just our ability to hedge.

Mr. NEUGEBAUER. Yes, ma'am. Ms. Cavallari.

Ms. CAVALLARI. Again, I couldn't agree more with Mr. Campbell. An important part of liquidity is also the diversity of the market participants, and having that diversity of market participants, it is just crucial that that be preserved because that just only contributes to the overall efficiency of these markets.

Mr. NEUGEBAUER. Anything? I think that one of the questions I would have, what is remaining, are there safeguards already in place that would—what people want to make sure with position limits is somehow somebody is manipulating the price by the number of positions they have. Do you feel like there are already within the system protections, and we don't need to tighten those rules up? It is a question.

Mr. CAMPBELL. I will go out on a limb here and try to answer it. I think everybody supports the ability to hedge. I think most people recognize the value of speculators and to providing liquidities and providing counterparties for those looking to hedge. I don't think anybody to date has actually identified what an excessive speculator looks like.

Mr. NEUGEBAUER. Yes.

Mr. CAMPBELL. So I will leave it at that. I think liquidity is vital to the entire financial system and the entire energy and commodity markets.

Mr. NEUGEBAUER. Well, we need people on both sides of the transaction or there is no marketplace.

Mr. CAMPBELL. Absolutely.

Mr. NEUGEBAUER. Mr. Chairman, thank you.

The CHAIRMAN. Thank you. I have one last question and then I will turn it over to Mr. Scott, if he has any closing comments, and then we will adjourn. But this deals with the recordkeeping. And Mr. Christie, the expanded recordkeeping requirements enacted by the CFTC, were they called for in the Dodd-Frank Act, and is the Commission's proposed relief adequate for you and for your customers on the recordkeeping?

Mr. CHRISTIE. Being several years down the road, it is probably difficult to form an opinion on what was initially envisioned. I do think that, to the extent that cash transactions and cash discussions are subject to the same recordkeeping records as futures transactions or swap transactions, that is a broader universe than what maybe was initially envisioned. So while there is clearly a connection between cash transactions and eventually derivative transactions, having comparable recording requirements is a pretty broad application.

The CHAIRMAN. All right.

Mr. Scott, before we adjourn, I just want to recognize you for any closing statements that you may have.

Mr. DAVID SCOTT of Georgia. Sure. First of all, this has been a very, very informative hearing. Before us is an opportunity to reintroduce some much-needed legislation, and we are going to basically mirror this legislation after the one we did last year, H.R. 4413, that will give some clarity. That would also mainly make sure end-users and the commodities and agriculture, energy, those that are not financial entities, are not dealt with the same way, because it is not fair to you.

I am also very concerned, as I mentioned in my statement, that we make sure, and I hope that as you move forward, it is very important that the CFTC have the financial resources to do this job. If it doesn't have those financial resources, I mean their workload has tripled as a result of the meltdown. Burnout rate has been tremendous. It is a new Commission. They are the ones that have to carry this forward to make sure we have smooth sailing in dealing with the swaps market and the derivatives. It is a very complicated, complex area. It is now nearly $700 trillion of the world's economy, and we are the biggest player in that economy, and we want to maintain that as we move with things like cross-border, push-out, all of that that affects end-users, that not be categorized in there where you have to be pushed out of one bank, where you need to be in there where you can do your hedging with—especially interest rate swaps, which is the pivot swap to hedgers. So this is a very complex, complicated area we are dealing with, and we want to make sure, and we will, that we get some good legislation that is bipartisan that reflects your concerns.

And again, we want to make sure—I am very worried about, as you can imagine from my comments, that we make sure that we give the CFTC the resources that are needed, because if they don't, it is going to back-up and be more detrimental to you.

So, Mr. Chairman, it is a pleasure working with you. This is our first hearing——

The CHAIRMAN. Thank you.

Mr. DAVID SCOTT of Georgia.—together.

The CHAIRMAN. Yes, sir.

Mr. DAVID SCOTT of Georgia. Thank you very much.

The CHAIRMAN. And I too am committed to a piece of legislation that will increase access and integrity in the market, because that is key for all of us. And I want to thank you for coming and testifying today. These are complex issues, and we need to hear from those of you who deal with them on a daily basis, so thank you all for coming.

And under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material, and supplementary written responses from the witnesses to any questions posed by a Member.

The Subcommittee on Commodity Exchanges, Energy, and Credit hearing is now adjourned.

[Whereupon, at 3:06 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED LETTER BY HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA; ON BEHALF OF PAUL N. CICIO, PRESIDENT, INDUSTRIAL ENERGY CONSUMERS OF AMERICA

March 24, 2015

Hon. AUSTIN SCOTT,
Chairman,
Subcommittee on Commodity Exchanges, Energy, and Credit,
House Committee on Agriculture,
Washington, D.C.;

Hon. DAVID SCOTT,
Ranking Minority Member,
Subcommittee on Commodity Exchanges, Energy, and Credit,
House Committee on Agriculture,
Washington, D.C.

Re: Public Hearing—CFTC Reauthorization

Dear Chairman Scott and Ranking Member Scott:

Thank you for having the hearing entitled "Reauthorizing the Commodity Futures Trading Commission: End-user Views." The Industrial Energy Consumers of America (IECA)* fully endorses the testimony of Howard Peterson, Owner and President of the Peterson's Oil Service in behalf of the New England Fuel Institute.

IECA represents energy-intensive trade-exposed manufacturing companies whose competitiveness is dependent upon the cost of natural gas and electricity. The industrial sector consumes up to ⅓ of the U.S. natural gas and electricity. Therefore, we are an important stakeholder on these important issues.

We look forward to working with you.

PAUL N. CICIO,
President.

SUBMITTED QUESTIONS

Response from Douglas Christie, President, Cargill Cotton; on Behalf of Commodity Markets Council

Questions Submitted by Hon. Austin Scott, a Representative in Congress from Georgia

Question 1. Mr. Christie it is my understanding that CFTC guidance and staff interpretations do not carry the weight of law and that CFTC staff "no-action" letters typically carry the disclaimer that the terms of the letter could be changed or revoked at any time. Why is the Commission rulemaking process with comment periods and votes better for business planning?

Answer. Notice and comment rulemaking allows for a full, complete and transparent exposition of CFTC's proposal by all parties involved in the rulemaking. The publication of the proposal allows the CFTC to explain the agency's point of view on the matter and allows the public time to consider those views and develop comments in response to the agency's point of view. This process is governed by the Administrative Procedures Act ("APA") which is generally understood by all parties. The process is transparent and known. Once a rule is finalized, participants in the process have confidence in the outcome and they have certainty because the rule cannot be changed absent a similar rulemaking, with notice and comment. This process also requires approval by a majority vote of the Commission.

The agency has made some regulatory decisions by staff "no-action" letters. This process lacks the transparency that is present in the full rulemaking process discussed above. Since the decisions are made at the staff level, not the Commissioner level, decisions could be revoked at any time. Many decisions made by the CFTC, whether through rulemaking or staff guidance require outlays of time and resources to ensure compliance by the regulated party. A staff "no-action" letter that could be revoked at any time could end up with sunk costs by regulated parties should the

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*The Industrial Energy Consumers of America is a nonpartisan association of leading manufacturing companies with $1.0 trillion in annual sales, over 2,900 facilities nationwide, and with more than 1.4 million employees worldwide. It is an organization created to promote the interests of manufacturing companies through advocacy and collaboration for which the availability, use and cost of energy, power or feedstock play a significant role in their ability to compete in domestic and world markets. IECA membership represents a diverse set of industries including: chemical, plastics, steel, iron ore, aluminum, paper, food processing, fertilizer, insulation, glass, industrial gases, pharmaceutical, building products, brewing, independent oil refining, and cement.

staff or the Commission revoke a no-action letter if staff change their view. This could occur without the due process that is afforded regulated parties under a public notice and comment rulemaking process set out in the APA. Rulemakings for compliance purposes should be subject to notice and comment rulemakings for this reason.

There may be instances in which an individual firm presents unique circumstances that the agency needs to judge on a case-by-case basis. In these cases staff "no-action" letters are entirely appropriate. This has been the history of staff "no-action" letters. The CFTC should reserve "no-action" letters for this purpose and not use them as an expedient substitute for notice and comment rulemaking. Otherwise, regulated entities may be deprived of due process, transparency and long-term confidence in the outcome.

Question 1a. Can you provide examples of a time when your businesses had to rely on the relief of a "no-action" letter or had to seek clarification on regulations from CFTC's general counsel? How did that process work? Legally, how comfortable were you in the result?

Answer. There have been circumstances in the past when Cargill has requested and received staff "no-action" letters. We have also had occasion to consult with the CFTC Office of General Counsel to receive clarification of Commission regulations. These steps were generally taken to better understand specific regulatory requirements or to clarify statutory obligations in the absence of regulatory guidance. The agency provided the necessary clarity needed at the time.

Question 2. Mr. Christie, in your testimony you discuss the deliverable supply data the Commission is using to inform its position limits rule, which you say is leading to "conservative estimates." Generally, we support erring on the side of caution. Can you explain why a conservative estimate is not a prudent option here?

Answer. The deliverable supply estimates used by the CFTC should be as accurate as possible to ensure that the position limits established by the agency are consistent with the volumes of product that are used in commerce. If the deliverable supply estimates are too conservative, then position limits may be set at too low a level to allow for price discovery and risk management. This could hinder the proper function of the marketplace for those market participants that use the markets for risk management.

Response from Lael E. Campbell, Director of Regulatory and Government Affairs, Constellation Energy (An Exelon Company); on Behalf of Edison Electric Institute

Questions Submitted by Hon. Austin Scott, a Representative in Congress from Georgia

Question 1. Mr. Campbell it is my understanding that CFTC guidance and staff interpretations do not carry the weight of law and that CFTC staff "no-action" letters typically carry the disclaimer that the terms of the letter could be changed or revoked at any time. Why is the Commission rulemaking process with comment periods and votes better for business planning?

Question 1a. Can you provide examples of a time when your businesses had to rely on the relief of a "no-action" letter or had to seek clarification on regulations from CFTC's general counsel? How did that process work? Legally, how comfortable were you in the result?

Answer 1–1a. Electric utilities value the regulatory certainty provided by a formal rulemaking process. As outlined in the Administrative Procedures Act, there are a number of benefits associated with a transparent rulemaking process with the notice and the opportunity for public comment. First, all interested and affected stakeholders have the opportunity to participate in the process using formal rules for participation which creates a public record. Second, all the Commissioners participate in the process and a majority need to agree in order to have a final rule. Third, the Commission needs to engage in this process in order to change the final rule. EEI members are non-financial entities that primarily participate in the physical commodity market and rely on swaps and futures contracts to hedge and mitigate their commercial risk. The goal of our member companies is to provide their consumers with reliable electric service at affordable and stable rates, which has a direct and significant impact on literally every area of the U.S. economy. Since wholesale electricity and natural gas historically have been two of the most volatile commodity groups, our member companies place a strong emphasis on managing the price volatility inherent in these wholesale commodity markets to the benefit of their consumers. The derivatives market has proven to be an extremely effective tool in insulating our consumers from this risk and price volatility. As such, the regulatory certainty provided by a formal rulemaking process is invaluable to EEI

members who rely on this certainty to make long term business decisions and investments in compliance and operational infrastructure.

In the absence of authoritative action by the Commission, "no action letters", notwithstanding their unofficial status, assume a considerable degree of importance to market participants in planning transactions and conducting business.[1] However, "No action letters" are not provided through a transparent process and affected stakeholders may not have the opportunity to provide comment or may not even know that a "no action letter" that could potentially affect their business is being contemplated. Since they are not formal Commission action, the letter does not bind Commissioners and can be revoked or expire.

There have been a number of instances where the industry has had to rely on the "clarification" as well as additional regulatory requirements imposed by "no action letters." These include no-action relief addressing the reporting of trade options, which imposed new regulatory requirements, no-action relief regarding the reporting of inter-affiliate transactions, and interpretive guidance under the products definition relating to facility usage contracts and forwards with embedded volumetric optionality. While these actions have provided welcome relief to EEI members and other end-users, they do not provide any long term certainty to the market as they lack formal legal authority.Although the clarifications in these no-action letters were needed, many EEI members have not been comfortable making long term investment decisions on these informal letters issued by Commission staff.

Question 2. Mr. Campbell, in your testimony, you raised concerns about the CFTC's position limit proposals. Do you think the exchanges do a sufficient job of setting and policing position limits in the energy markets? Are there potential consequences to limiting the ability of participants to trade in derivatives markets?

Answer. Yes, EEI members that conduct hedging transactions on DCMs are comfortable with the way position limits are administered at the exchange level. Exchanges have experience with our hedging practices and there is confidence from energy market participants that they will appropriately administer their position limits regimes and recognize industry-accepted hedging practices. The exchange administration of position limits incorporates both enumerated and non-enumerated hedge exemptions. This is why it is so critical that Congress preserve a *bona fide* hedge definition that does not restrict the broad recognition of hedging activities that are required to manage risk in the complex world of physical commodities.

Limitations on the ability of participants to trade in derivatives markets have a detrimental impact on liquidity, the most vital element of a well-functioning market. Inadequate liquidity widens bid/ask spreads, adds volatility to the market, negatively impacts price transparency, and increases the cost of hedging all around. The risks and costs of illiquid markets ultimately will be reflected in higher prices paid by end use consumers.

The derivatives market has proven to be an extremely effective tool in insulating our consumers from this risk and price volatility. However, as market liquidity goes away the markets become less effective in reaching this goal. Legislators and policy makers should be doing everything in their power to *increase* liquidity in the market. Instead regulatory trends have had the opposite impact of decreasing liquidity, which increases risk, increases hedging costs, and ultimately results in an increase of the price consumers pay for the energy we provide.

Question 3. Mr. Campbell, how have energy companies, specifically, been impacted by the CFTC deciding to regulate forward contracts with imbedded "volumetric optionality" as swaps? What are the future consequences of this regulatory overreach if the CFTC does not change its regulations? Does the CFTC's proposed rule regarding volumetric optionality address industry concern? If not, what more needs to be done to provide companies the certainty they need to continue operating under their current business models?

Answer. The Commission has created significant regulatory uncertainty and regulatory costs for end-users, such as EEI members, by determining, contrary to 30

[1] Section 140.99 of the Commodity Exchange Act defines "no actions letters" as a written statement issued by the staff of a Division of the Commission or of the Office of the General Counsel that it will not recommend enforcement action to the Commission for failure to comply with a specific provision of the Act or of a Commission rule, regulation or order if a proposed transaction is completed or a proposed activity is conducted by the Beneficiary. A no-action letter represents the position only of the Division that issued it, or the Office of the General Counsel if issued thereby. A no-action letter binds only the issuing Division or the Office of the General Counsel, as applicable, and not the Commission or other Commission staff. Only the Beneficiary may rely upon the "no-action letter." As such, no action letters are informal and advisory, rather than official and definitive. Courts may also rely on a "no action letter" to resolve legal disputes.

years of precedent and the clear language of the CEA, that all commodity options, including commodity trade options that are intended to physically-settle, are included in the defined term "swap." CEA 1a(47) provides that a commodity option is a "swap," ***except*** if the nonfinancial commodity transaction for deferred shipment or delivery is intended to be physically settled. By classifying these physically settled transactions as trade options with recordkeeping and reporting requirements, the Commission has imposed regulatory costs on end-users on contracts that are traditionally used to manage the volatility in the electric and natural gas markets as well as customer needs.

While the Commission has tried to address industry concerns by issuing further clarification on the seven factor test for volumetric optionality as well as its proposed trade option rule, the relief does not go far enough as it still requires end-users to jump through regulatory tests that still may result in contracts that are intended to physically settle falling under the CFTC's definition of a "Swap". The best outcome would be for the Commission, consistent with the language in the CEA, to exclude from the definition of a "Swap" all transactions that are intended to be physically settled at the time the contract is entered into. This would provide clear guidance to the industry and allow them to continue to meet the needs of its consumers.

Question 4. Mr. Campbell, the swap dealer *de minimis* threshold is based on notional value. That may work for interest rate swaps, but in the commodities markets rising prices could push entities over the threshold without them changing their trading. In fact, entities might be forced to reduce trading when faced with rising prices, reducing liquidity at exactly the wrong time. How do you suggest the CFTC address this issue?

Answer. Regulatory certainty and the opportunity for regulatory input are important to our industry. Rather than have a regulatory cliff in which there is a dramatic reduction from $8 billion to $3 billion absent Commission action, the Commission should be required to affirmatively act and solicit comments through a transparent rulemaking process before making any changes. A deep automatic reduction in the *de minimis* level could hinder the ability of end-users to hedge market risk while imposing unnecessary costs that eventually will be borne by consumers.

Under current market conditions, where we are at a low price point in the commodity cycle, $8 billion is an appropriate floor for the swap dealer *de minimis* threshold. While the current threshold has resulted in entities that are materially engaged in the business of swap dealing to register, it has not stifled the ability for end-users to enter into swaps with each other, which is very critical in energy markets. However, as commodity prices increase EEI members may encounter unnecessary pressure under the current $8 billion threshold. One way to address this would be to establish $8 billion as a floor, but provide a mechanism whereby the threshold could increase over time as commodity prices increase, similar to the annual adjustment of the consumer price index.

Response from Lisa A. Cavallari, Director of Fixed Income Derivatives, Russell Investments; on Behalf of American Benefits Council

Questions Submitted by Hon. Austin Scott, a Representative in Congress from Georgia

Question 1. Ms. Cavallari, it is my understanding that CFTC guidance and staff interpretations do not carry the weight of law and that CFTC staff "no-action" letters typically carry the disclaimer that the terms of the letter could be changed or revoked at any time. Why is the Commission rulemaking process with comment periods and votes better for business planning?

Answer. The traditional rulemaking lifecycle involves proposed rules, consultations and comment periods, and sometimes public hearings, all of which eventually lead to final rules. Industry engagement and cooperation with regulators plays a critical role in helping to inform the Commission and its staff and to improve the effect of final rules. Business planning mirrors the iterative rulemaking process. As the regulatory process reaches its crescendo, business planning must become concrete and actionable as businesses need to invest in and implement new systems, personnel, controls, and tools to help comply with forthcoming regulations.

No-action letters serve a tremendously important role in the regulatory process. It is unrealistic to expect that any regulatory agency will get a new regulation 'right' on the first try. What works for 95% of the market may not make sense for the other 5% of the market so regulators need the latitude to adapt. No-action letter relief is a valuable, cost and time efficient tool to regulators and the regulated alike in that it enables regulators to navigate untested waters and adjust for unintended consequences that could not have been fully anticipated in the rulemaking process.

But it is just that . . . an instrument for fine tuning, not a substitute for thoughtful regulation. Among many reasons for this is that no-action letters are highly fact specific and often highly company or product specific. This limits their utility to the broader market. Furthermore, because they are fact dependent and not principles-based, they can quickly become dated as technology or best practices evolve. This further limits their utility and, unlike principles-based regulation, does not promote innovation and could, at worst, stifle innovation. Last, where no-action relief or other regulatory guidance is intended to be of market-wide application, it provides far less certainty than regulation which is less susceptible to revocation or rapid change.

Question 1a. Can you provide examples of a time when your businesses had to rely on the relief of a "no-action" letter or had to seek clarification on regulations from CFTC's general counsel?

Answer. Russell has relied on no-action letters with respect to certain aspects of derivatives trading such as No-Action Letter 14–01 which extended temporary no-action relief from certain Dodd-Frank cross-border swaps activities. We have not, however, directly sought clarification from CFTC's general counsel about CFTC regulations.

Question 1b. How did that process work? Legally, how comfortable were you in the result?

Answer. Using No-Action Letter 14–01 as an example, the process was not ideal. While the relief was appropriate and welcomed, it provided only temporary relief to a highly complex challenge facing global regulators and markets. Ahead of the expiration of the relief (first in January 2014 and then again in September 2014), businesses like ours had to anticipate and plan as though that relief may not be extended or that the rules themselves may not be modified. All too often, relief comes at the 11th hour. This amplifies the ambiguity and consumes valuable resources, neither of which helps us achieve our purpose of improving financial security for our clients.

Question 2. Ms. Cavallari, some, including Commissioner Giancarlo, have suggested that imposing futures-market style rules on the unregulated swaps market was a mistake. Do you agree with this assessment?

Answer. Yes. The OTC swaps market grew independently of futures markets largely because specific investment needs could not be met directly using futures. At Russell, we believe that there is a place for listed futures, cleared swaps and other bilateral OTC swap products. Futures market style rules will never fully displace cleared or bilateral OTC swaps.

Question 2a. Have the new rules been harmful to your clients?

Answer. Some of the rules have been detrimental to our clients, especially those imposing futures-type rules. As Commissioner Giancarlo iterates in his white paper, *Pro-Reform Reconsideration of the CFTC Saps Trading Rules: Return to Dodd-Frank,* such rules are an artificial construct.

Question 3. Ms. Cavallari, can you explain how the Commission's proposed position limits and aggregation rules would impact pension funds?

Answer. Russell interprets this question as directed towards commodities. Pension plans allocate to a wide variety of asset classes and commodities can be an appropriate asset class for pension plans. Access to commodities exposure is obtained from both futures and OTC swaps. Position limits and aggregation are metrics that both a swap dealer and a pension plan must acknowledge and track. A swap dealer may become constrained in terms of what it can offer a pension plan customer due to position limits. This prevents a Russell pension plan client from obtaining exposure vital for the plan. Alternatively the limits could create a situation where the swaps offered by the swap dealer are prohibitively expensive. For a pension plan, real-time continuous monitoring of all of its investment managers' commodities holdings may not be operationally feasible. If this is the case, the plan may choose to avoid the commodities allocation altogether. This would be a sub-optimal outcome.

Question 3a. From your perspectives, is it possible to comply with them as they have been proposed?

Answer. Currently, the rules create a number of operational challenges for our clients as noted and may eventually curb their access to these important risk-hedging products.

Question 4. Ms. Cavallari, the Commodity Exchange Act states that the Act shall not apply to swap activities outside the United States that do not have a "direct and significant" connection with activities in, or effect on, commerce of the United

States. Has the CFTC adequately clarified what exactly is a "direct and significant" connection to U.S. commerce?

Answer. No.

Question 4a. How do you and your customers comply with the CFTC's guidance?

Answer. Russell spends a great deal of time attempting to triangulate between (i) the domicile of our clients who use our trading services, primarily our commingled funds and third-party institutional clients such as pension funds, (ii) the domicile of the swap dealer who is facilitating compliance, and (iii) the domicile of other parties who are part of the trading process such as custodians or other investment managers to whom we outsource some investment activities for our funds or clients. The ambiguity of the current regulations is immense and creates challenges for firms like ourselves, for our vendors, and for our clients to navigate especially in this globally interconnected world where staff of all parties is dispersed. This challenge is amplified due to similar emerging regulating coming into force in other global markets with inadequate harmonization or coordination. Moreover, as we learned during the Global Financial Crisis and other events involving financial volatility, our markets are inextricably tied such that, in any given situation, someone could claim that an activity has the potential to have a direct and significant connection with activities in, or effect on, the United States.

Response from Mark Maurer, Chief Executive Officer, INTL FCStone Markets, LLC

Question Submitted by Hon. Austin Scott, a Representative in Congress from Georgia

Question. Mr. Maurer can you explain how the Commission's proposed position limits and aggregation rules would impact swaps dealers? From your perspectives, is it possible to comply with them as they have been proposed?

Answer. Three main points on position limits affect INTL FCStone Markets, LLC's customers:

1. The market requires a broader definition of a *bona fide* hedge. The definition should not operate in practice to restrict normal hedging practices. If it does, then it will disrupt the marketplace and our customer's operations.
2. In practice, scaling down position limits should not affect cash contracts, as this disrupts the ability of the futures contract to mimic a true hedge. Requiring hedgers to get out of a contract that is cash settled disrupts the intended purpose of the hedge exemption.
3. On spreads, there is danger in taking a narrow view of absolute price risk. We must not fail to consider the multiple risks of a commercial operation, otherwise, we risk bid-offer spreads and credit risk spreads will widen and reduce liquidity. This leads to wider risk premiums throughout the business channel, which will ultimately be a cost passed on to end-users and consumers.

    - The industry expressed concern about the CFTC's view of unfixed price commitments, which failed to recognize hedging needs of unfixed price contracts (*i.e.,* basis contracts) as *bona fide* hedging. The business of merchandising is conducted substantially in the form of basis contracts. Merchants must be allowed to utilize hedging strategies, including calendar spread hedging to manage this risk.
    - One of the main reasons for hedging is to turn flat price risk into relative risk, and by taking flat price risk and offsetting it with a futures position, a commercial firm creates exactly unfixed or basis positions, the same positions the CFTC has resisted to recognize as a *bona fide* hedge.
    - Although basis risk is generally less volatile than flat price risk, it is not always the case—basis and unfixed positions still maintain risk and must be allowed to be hedged, managed and recognized.
    - Attached, CMC's comment letter which INTL FCStone Markets, LLC participated in drafting, illustrates informative examples.

Last, I wish to take this opportunity to reiterate our concerns regarding margin for uncleared swaps.

B. Margin for Uncleared Swaps:

- Many swap dealers expect to continue to collect margin from end-users in order to manage risk, even if the rules say it is not required for end-users.
- To the extent swap dealers continue to collect margin, many in the industry believe that the treatment of margin should remain intact, *i.e.,* the swap deal-

ers be allowed to use that margin to purchase futures contracts to mitigate risk, and manage the customer's hedge.

- Of course, if customers seek to segregate margin, they have the option to do so. However, the requirement to segregate margin should not be mandatory, if, margin is used to facilitate the customer's hedge, which will retain costs to end-users and consumers at current levels, rather than shift extraordinary costs to end-users and customers.
- Attached, INTL FCStone Market's comment letter in this regard.

Please give me a call with any questions or if INTL FCStone Markets, LLC can be of further assistance. These are critically important issues to our agricultural customers, and all of our customers appreciate an approach aimed to facilitate their important commercial hedging needs.

Regards,

CATHERINE E. NAPOLITANO,
Deputy General Counsel.

ATTACHMENT 1

March 28, 2015

Via Electronic Submission

CHRIS KIRKPATRICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

Re: **Re-Opening of Comment Period Regarding the Commodity Futures Trading Commission Energy and Environmental Markets Advisory Committee Discussion of Position Limits for Derivatives (RIN 3038–AD99) and Aggregation of Positions (RIN 3038–AD82).**

Dear Mr. Kirkpatrick:

The Commodity Markets Council ("CMC") appreciates the opportunity to submit the following comments to the Commodity Futures Trading Commission (the "CFTC" or "Commission") as part of its reopening of the comment period for its proposed rules on position limits for physical commodity derivatives and the aggregation of positions.[1]

I. Introduction

CMC is a trade association that brings together exchanges and their industry counterparts. Its members include commercial end-users which utilize the futures and swaps markets for agriculture, energy, metal and soft commodities. Its industry member firms also include regular users of such designated contract markets (each, a "DCM") as the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures U.S., Minneapolis Grain Exchange and the New York Mercantile Exchange. They also include users of swap execution facilities (each, a "SEF"). The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCMs, SEFs or over-the-counter ("OTC") markets. As a result, CMC is well positioned to provide a consensus view of commercial end-users on the impact of the Commission's proposed regulations on derivatives markets. Its comments, however, represent the collective view of CMC's members, including end-users, intermediaries and exchanges.

II. The Proposed Position Limits

The CMC has submitted several comment letters to the Commission regarding its Proposed Position Limits rules.[2] Rather than repeat prior comments, the CMC would like to use this opportunity to highlight some of the issues raised at the February 26, 2015 Energy and Environmental Markets Advisory Committee ("EEMAC") meeting and issues related to the new position limits table 11a.

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[1] See *Position Limits for Derivatives and Aggregation of Positions,* 80 FED. REG. 10022 (Feb. 25, 2015) (proposed rule, reopening of comment period).

[2] September 24, 2013—*http://www.commoditymkts.org/wp-content/uploads/2014/05/CMC-Final-Anticipatory-Hedge-9.24.13.pdf;* February 10, 2014—*http://www.commoditymkts.org/wp-content/uploads/2014/05/CMC-Position-Limits-Comment-Letter-2-10-2014.pdf;* July 25, 2014—*http://www.commoditymkts.org/wp-content/uploads/2014/07/CMC-PL-Roundtable-Comment-Letter-FINAL.pdf;* January 22, 2015—*http://www.commoditymkts.org/wp-content/uploads/2015/02/CMC-Position-Limits-Comment-Letter-1.22.15-AS-FILED-.pdf.*

Comments Related to the February 26, 2015 EEMAC Meeting

A. *Bona Fide* Hedging in General

Pursuant to the Dodd-Frank Act, position limits are to be used, not to prevent speculation, but only to prevent excessive speculation, to the extent it exists. Dodd-Frank was never intended to focus on commercial market participants, such as CMC members, engaging in hedging activity. This is not surprising given that the list of market events that led to the passage of Dodd-Frank does not include trading in the agriculture or energy markets, and it certainly does not include allegations of speculative trading by commercial market participants disguised as *bona fide* hedging. Unfortunately, in an attempt to address concerns about how one might disguise speculative conduct as hedging, the proposed rules will curb the legitimate practice of hedging.

Unfortunately, the proposed rules will curb the practice of hedging by producers, end-users and merchants. Merchants play a critical role in the marketplace by, among other things, promoting convergence between the physical and futures markets. Convergence is a crucial aspect of the price discovery function and markets with effective convergence ultimately reduce risk and provide liquidity. Merchants face, accept, and manage several different types of risks in the supply chain. Commercial merchants face countless risks including, but not limited to: absolute price risk, relative price risk (which is basis or unfixed risk), calendar spread risk, time risk, location risk, quality risk, execution and logistics risk, credit risk, counterparty risk, default risk, weather risk, sovereign risk, and government policy risk. It is important to recognize that all of these risks directly impact the commercial operations of a merchant and ultimately affect the value of the merchant's commercial enterprises and the price merchants pay or receive for their product. Merchants must be able to make a decision on how not only to price these risks in a commercial transaction, but also how to manage these risks. The ability to manage these risks not only benefits the merchants, but also the supplier and ultimate consumer of the finished good.

In negotiating a forward contract with a potential counterparty, the merchant must take into consideration all of the above risks to make the most appropriate decision regarding if, when, and how to utilize exchange traded futures to hedge multiple risks that are present—as each risk ultimately affects price. This means both the price to the seller of the raw commodity and the price to the consumer of the final product. The Commission is taking a narrow view of risk, focusing solely on the absolute price risk of a transaction with a counterparty, and is not considering the multiple risks that exist in a commercial operation or enterprise. The logical result of such an approach is that bid offer spreads and credit risk spreads will widen and liquidity will be reduced. This will lead to wider risk premiums throughout the business channel, which will ultimately be passed along to end consumers who will bear the costs.

B. Economically Appropriate Test

The language of the "economically appropriate" test has been in the law and regulations for a long time, but the proposal's new interpretation is different. The proposal suggests that to qualify for the economically appropriate test, an entity has to consider all of its exposures when doing a risk reducing transaction and the entity itself cannot take into account exposures on a legal entity, division, trading desk, or even on an asset basis. Rather, all exposure has to be consolidated and then analyzed as to whether or not the transaction reduces the risk to the entire enterprise. This new interpretation substitutes a governmentally imposed one-size-fits-all risk management paradigm for a company doing its own prudent risk management business in light of its own facts and circumstances. Such an interpretation would require commercial entities to build a system to manage risk this way—a system that does not exist today because it does not provide risk management value.

C. Enumerated Hedges

The proposal changes current CFTC rule 1.3(z), which states that enumerated hedges or *bona fide* hedges include, but "are not limited to," a list of enumerated hedging transactions. The proposal lists permitted enumerated hedging transactions and provides little flexibility to market participants. Having a finite list is difficult for market participants who must manage risk because no one can be expected to understand or anticipate every type of hedge that can be done or that fits all markets or market participants. Also, the enumerated hedges that are listed in the proposed rule discount the importance of merchandising and anticipatory hedging. The concept of enumerated hedging transactions focuses much more on the absolute fixed price risk with a counterparty, and inappropriately so. The majority of energy and agricultural merchandising transactions, and associated risk management are

generally done on a relative (*i.e.,* not fixed) price basis. The examples set forth below illustrate this principle.

D. Merchandising

Merchandising should not be pinned into a specific hedge category as it is a broad concept and connects the two ends of the value chain, production and consumption. One example provided at the February 26, 2015 roundtable that is illustrative of this concept is as follows:

> Take for example a commodity (*i.e.,* gas oil/diesel) that is being priced at a level in New York ("NY") that demonstrates to the merchandiser that the commodity is in greater demand in that area than and in another area (*i.e.,* Europe). The underlying is traded on ICE Europe as a gas oil contract and in NY Harbor as a CME ULSD (Ultra Low Sulfur Deisel) contract.
>
> For purposes of example, on January 19th, gas oil was trading at about $1.51 in Europe and diesel was trading at $1.66 in NY Harbor. On January 19th, a NY importer would buy physical gas for forward delivery on a floating price basis against the ICE futures. The importer has not yet located a buyer for the product in NY, but intends to ship the gasoline to NY and sell it on a floating price basis and capture that price differential. The importer locks in the ULSD gas oil differential of 15¢ by buying the ICE Feb gas oil futures at $1.51 and selling to NYMEX at $1.66. The short NY ULSD futures would not qualify for *bona fide* hedging treatment under the proposed rule, even though it is an essential component of the transaction that allows the importer to take the gas oil from Europe where it is in relatively excess supply and bring it to NY where the prices in the market are dictating that it ought to be sold and delivered.
>
> On January 26th the importer finds a buyer in NY Harbor and sells it on a floating price basis. At that point, he has a floating price buy and a floating price sale, and the rules would permit it as a *bona fide* hedge. But for that interim period (a week in this example), it is not a *bona fide* hedge. On January 29th, both counterparties to the importer agreed to price the commodity, and take the indexes that they agreed to use for pricing, and they look at the prices and establish them as the prices for their physical transactions—in this case, the importer could buy actual physical gas oil at $1.5268, sell physical in NY at $1.6184 and have revenue from that transaction of 9¢ a gallon. At the same time, the importer would liquidate the futures spread and (in this case) recognize again on the futures transactions 6¢ a gallon. The revenue of the two together is about 15¢, and when you take out the costs that he anticipated (about 14.5¢), it yields the expected gain of about ¾¢ per gallon—exactly what he hoped to accomplish by hedging and moving the product where it was needed. So even though the price of ULSD dropped by about 40% relative to the price of gas oil in Europe, and dropped by 5¢ in absolute terms, through the use of this hedge the importer was able to preserve the economics of his transaction and move the cargo.
>
> The one week transaction (where he had an unfixed purchase in Europe and had not yet established his unfixed price sale in NY) should qualify as a *bona fide* hedge because it meets all of the statutory requirements. Namely, the transaction: (1) was a substitute for a transaction to be made at a later time in a physical marketing channel, *i.e.,* the sale of physical product in NY Harbor; (2) was economically appropriate to the reduction of his risk in that the relative value of the product in NY Harbor could drop before he sold the product on a floating price basis; (3) arose from the potential change in value of an asset (gas oil) that the importer owned after he made the purchase in Europe; and (4) the consumer benefits from this transaction because gas oil was imported to the U.S. in response to market signals, ultimately reducing the cost of fuel in the U.S. The importer would not have entered into this transaction without the ability to hedge his risk.

Another illustrative example provided at the February 26, 2015 roundtable involving winter storage of natural gas:

> A natural gas supplier in April 2013, leases storage in order to store and provide gas during the 2015–2016 winter season. Assume the supplier leased storage and his expected cost for storage is 38¢ per MMBTU, but in June 2013, market conditions are such that he is able to lock in a profit associated with that storage by using the futures markets. The supplier can buy October 2015, gas on the market for $4.299 per MMBTU and can sell gas, which would come out of storage in January 2016, for $4.69 per MMBTU. The supplier enters into that transaction in the futures markets by buying October natural gas futures and selling January natural gas futures, and locks in that differential. Neither

the October nor the January futures contracts would qualify for *bona fide* hedge treatment under the proposed rule. But in September 2015, when the natural gas physical market is active, the supplier is going to buy the gas that he will use to fill his storage in October 2015. When this occurs, the supplier will liquidate his October natural gas futures contract. In December 2015, when the supplier needs to supply his customers (*i.e.,* local utilities), he will sell the gas to be withdrawn from storage and liquidate the January natural gas futures contracts.

This storage transaction should be given *bona fide* hedging treatment because it satisfies the statutory standards established by Congress—it was a substitute for transactions to be made at a later time in a physical marketing channel, *i.e.,* the purchase of natural gas to fill storage and a sale to withdraw from storage—which was economically appropriate to the reduction of the supplier's risk that he will be able to recover the cost of its storage obligation and separately that he can profit from his business of supplying gas in the winter. This arose from the potential change in the value of an asset (natural gas storage) that the supplier owned and the gas itself that he anticipated owning. Consumers benefit from this transaction because it assures that gas will be in storage during the winter heating season in 2015–2016. The supplier would not have entered into the transaction to commit to storage without the ability to hedge its risk. The supplier wants to hedge the value of his storage not yet leased. If the prices move against him, he will not lease that storage but the futures markets allow him to lock in the value of his asset by hedging in the futures markets.

CMC members are very concerned by the Commission's view of unfixed price commitments. The Commission has failed to recognize hedging needs of unfixed price contracts (*i.e.,* basis contracts) as *bona fide* hedging. The business of merchandising is conducted substantially in the form of basis contracts and merchants must be allowed to utilize hedging strategies, including calendar spread hedging to manage this risk. One of the main reasons for hedging is to turn flat price risk into relative risk, and by taking flat price risk and offsetting it with a futures position, a commercial firm creates exactly unfixed or basis positions, the same positions the Commission does not want to recognize as a *bona fide* hedge. Although basis risk is generally less volatile than flat price risk, it is not always the case—basis and unfixed positions still maintain risk and must be allowed to be hedged, managed and recognized.

Recognizing unfixed price transactions in the marketplace is essential to protect market participants, banks, consumer and producers. Unfixed price contracts exist for several reasons, one to minimize the transaction risk from the time that the original transaction is made until closer in time to the ultimate delivery. Unfixed price contracts provide for much greater security with regard to counterparty, credit and default risk by allowing the parties to remain unfixed until closer in time to the period of the final execution of the contract, thereby minimizing the effect of potential price variance that could take place. If the hedging of these contracts were not allowed to be recognized as *bona fide* hedges, the Commission would force commercial enterprises to move toward a fixed price regime with offsetting hedges in the commodity futures market at great expense to suppliers, merchandisers and consumers.

CMC's concern with the Commission's view of unfixed price contracts is not limited to energy markets. Agriculture markets will also be adversely affected by the inability to hedge unfixed price contracts. Below is an example of an unfixed price commitment by a merchandiser of soybeans in the international grain market:

On January 23, 2015, Merchant enters into a contract to sell 4 cargoes (vessels) of soybeans to a counterpary in Asia ("Customer"). The total number of bushels of soybeans sold to Customer is 8 million, or the equivalent of 1,600 futures contracts. Terms of the contract are as follows:

- FOB Vessel—New Orleans, Louisiana (*i.e.,* shipper is responsible for getting a boat to the port of New Orleans and getting the soybeans on the boat).
- First half May 2015 delivery.
- Price: 75¢ over the May 2015 CBOT Soybean futures contract.
- Customer has the option to fix the price by delivery of May 2015 futures to Merchant via an "Exchange for Physical", or EFP, prior to May 1, 2015.

Merchant will need to purchase four cargoes of soybeans and transport them to the export elevator in New Orleans, Louisiana in time to load four vessels in the first half of May 2015. Merchant must decide how best to procure the

soybeans for the sale to Customer. The May 2015 futures contract will not provide supply protection for Merchant's commitment to Customer because the CBOT futures delivery for May 2015 soybeans is not in time to satisfy Merchant's contractual commitment. Merchant therefore needs time protection to cover its sale and decides that the March 2015 futures contract is the best solution. On the date of the sale to Customer, the CBOT futures price for March 2015 soybeans was $9.72 per bushel and the CBOT futures price of May 2015 soybeans was $9.79 per bushel. Thus, the March 2015 contract was priced 7¢ per bushel below the May 2015 contract. Since Merchant's best supply protection is the March 2015 futures contract and the commitment to Customer is indexed to the May 2015 futures contract, Merchant is exposed to calendar spread risk. If the March futures contract were to narrow or go above the May futures contract, the transaction with Customer could incur large losses. Merchant decides to protect its commitment to Customer and lock in the discounted price of the March futures contract compared to the May futures contract by purchasing 1,600 March 2015 futures and selling 1,600 May 2015 futures.

Merchant will eventually receive 1,600 long May 2015 futures from Customer via an EFP whenever Customer decides to fix its purchase contract prior to May 1, 2015. Merchant's short May 2015 futures position will be offset by the long futures received from Customer.

Merchant begins purchasing soybeans in the most economically appropriate manner. Merchant procures from various sources in the physical market. As Merchant purchases soybeans on fixed price basis and as unfixed price sellers fix their sales, Merchant sells March 2015 futures to offset its long March 2015 futures.

As Merchant approaches March 2015 futures delivery, the physical market for soybeans begins to trade at price levels in excess of the CBOT delivery value for March 2015. Merchant takes delivery of 1,000 contracts through the March 2015 CBOT delivery process and uses the soybeans to supplement other soybeans purchased in the physical market in order to fulfill its sales commitment to Customer.

On April 23, Customer delivers 1,600 futures contracts to Merchant via an EFP. The contract pricing between Merchant and Customer is now fixed prior to the time specified in the contract between the parties.

The above transaction is an example of what has been the standard of international grain merchandising for many years. However, under the proposed rule, Merchant would not be allowed to enter into the calendar spread transaction to hedge its risk, thus it would not be able to hedge its contractual physical supply commitment to Customer. This could impede convergence of futures and physical markets. The Commission's reasoning for denying *bona fide* hedging treatment is based on the sole fact that the sales contract to Customer was not a fixed price commitment at the time of the hedge by the Merchant. The consequences of the Commission's narrow interpretation of *bona fide* hedging will force Merchant to change the manner in which it merchandises to end-users. Merchant, in order to protect its ability to utilize futures as a hedge against physical supply commitments, may be forced to contractually require Customer to fix its May 2015 soybean contract by "first notice day" of the March 2015 soybean futures contract. Thus, in effect, the unintended consequence of this rule change may be that the Commission is mandating the date by which the end-user prices its soybeans.

Similar to the energy examples listed above, the agricultural merchandising example should be given *bona fide* hedging treatment because it satisfies the statutory standards established by Congress (it was a substitute for transactions to be made at a later time in a physical marketing channel and was economically appropriate to the reduction of risks in the commercial enterprise as the hedge protected the potential change in value of soybeans being merchandised).

Comments Related to the Revised Table 11a Position Limits

In previous comment letters, CMC, along with its members, has advised the CFTC that at whatever level single month and all months combined limits are set, parity should be maintained among the three primary U.S. wheat contracts—CBOT Wheat, KCBT Hard Winter Wheat, and MGEX Hard Red Spring Wheat. Under the Proposed Rule, each of the three contracts will be subject to different single month and all months combined limits, doing away with the parity approach that has worked for decades.

Revised Table 11a illustrates the destructive effects that the elimination of wheat parity will have in the marketplace. A comparison of Table 11 and Revised Table 11a reveals that while the unique persons holding positions in KCBT Hard Winter

Wheat and CBOT Wheat remain relatively constant, the unique persons holding positions in MGEX Hard Red Spring Wheat skyrocket in every identified category, to a factor far in excess of the other two contracts.

The disproportionate impact of the Proposed Rule impedes legitimate risk management strategies across the three wheat contracts, such as cross-hedging and spread trading. It forces a hedger seeking to spread CBOT Wheat and MGEX Hard Red Spring Wheat to either (1) limit their spread trading to the lowest threshold; (2) apply for *bona fide* hedge exemptions in certain contracts, or; (3) cease using the futures markets for risk management. None of these options are desirable.

Wheat parity has proved effective for decades, and the CFTC has not put forth any evidence that would warrant a move away from wheat parity in the Proposed Rule. Given the adverse implications of the divergent single month and all months combined limits for the three major U.S. wheat contracts, CMC urges the CFTC to maintain the historical success of wheat parity at whatever quantitative limit is established.

III. Conclusion

Thank you for the opportunity to provide comments on the commercial impacts of these rulemakings. If you have any questions or concerns, please do not hesitate to contact Kevin Batteh at *Kevin.Batteh@Commoditymkts.org*.

Sincerely,

Ken Batteh

KEVIN K. BATTEH,
General Counsel,
Commodity Markets Council.

ATTACHMENT 2

December 2, 2014

CHRISTOPHER KIRKPATRICK,
Secretary,
Commodity Futures Trading Commission,
Washington, D.C.

Re: ***Margin Requirements for Swap Dealers and Major Swap Participants,*** *79 FED. REG.* ***59898 (October 3, 2014); RIN 3038–AC97***

Dear Mr. Kirkpatrick:

INTL FCStone, Inc. and its affiliates (collectively, "**INTL FCStone**" or the "**Company**") thank the Commodity Futures Trading Commission (the "Commission" or "CFTC") for the opportunity to comment on the proposed rule regarding Margin Requirements for Swap Dealers and Major Swap Participants (the "**Proposed Margin Rules**" or "**Proposed Rules**").[1]

INTL FCStone is a financial services company that provides its 20,000+ customers across the globe with execution and advisory services in commodities, capital markets, currencies, and asset management. INTL FCStone Markets, LLC ("**IFM**") is a wholly-owned subsidiary of INTL FCStone and a provisionally registered swap dealer.

Through its international network of more than 1,000 employees, IFM's core business is helping mid-sized commodity producers, processors, merchants and end-users understand and mitigate their commodity price risk. Unlike many of the big banks and other financial institutions that have and are likely to register as swap dealers, IFM's counterparties are largely farmers, elevators, processors and merchants of agricultural commodities. Mitigation of commodity price risk is critical to the success of these market participants and non-centrally cleared swaps play an important role in these mitigation strategies. For a number of reasons, including the relatively smaller size of their commercial operations and related hedging transaction needs, and their dispersed geographic locations, these mid-market commercial clients typically do not have access to the risk management services of swap dealers that are affiliated with Bank Holding Companies. Nevertheless, this mid-sized commercial customer base in aggregate produces, processes, merchandises and/or uses a significant portion of U.S. domestic agricultural production. Without the changes to the Proposed Margin Rules discussed in this letter, the risk management services provided by IFM and other mid-market non-bank Swap Dealers may be too cost pro-

[1] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants;* Proposed Rule, 79 FED. REG. 59898 (October 3, 2014).

hibitive to the smaller and mid-market end-users. As a result, many of the risks of these end-users are likely to remain un-hedged.

For the reasons explained in greater detail below, IFM respectfully requests that the Commission make the following specific revisions to, or clarifications of, the Proposed Margin Rules:

- **Calculation of Initial Margin.** The Commission should limit the posting and segregation of excess margin by allowing swap dealers and major swap participants (collectively, "**Covered Swap Entities**" or "**CSEs**") to submit margin methodology filings as self-executing filings if the methodologies have previously been approved on behalf of their affiliates by other regulators, including foreign regulators that have implemented margin regimes consistent with the BCBS–IOSCO Margin Requirements for Non-Centrally Cleared Derivatives (the "**BCBS–IOSCO Framework**").[2] In addition, the Commission should encourage the use of standardized models developed by industry groups by allowing CSEs to submit such models as self-executing filings if they have been approved for use by another market participant.
- **Threshold for Material Swaps Exposure:** The Proposed Rules incorporate a "material swaps exposure" ("**MSE**") threshold of $3 billion, which is substantially lower than the $11 billion (€8 billion) volume-based exception included in the BCBS–IOSCO Framework and the margin proposal issued by the European Supervisory Authorities (the "**European Proposal**").[3] We do not believe that the analysis contained in the Proposed Rules provides sufficient support for this difference because the analysis implicitly assumes that financial end-users trade with only a single counterparty, when in practice such concentration of trading activity is rare. Accordingly, the Commission should conform to the BCBS–IOSCO Framework and European Proposal or, in the alternative, defer final adoption of the MSE definition until the Commission has conducted a more thorough analysis of the uncleared swap markets.
- **Re-Use of Posted Margin.** The Proposed Rules do not permit initial margin, which must be held by a third-party custodian, to be rehypothecated, repledged, or reused. The margin rules should instead provide that reuse of posted margin is acceptable if the relevant model were to meet the standards proposed in the BCBS/IOSCO Framework. In addition, the Department of the Treasury, the Federal Reserve and other prudential regulators (the "**Prudential Regulators**") and the Securities and Exchange Commission may permit reuse of posted margin,[4] and if so, a prohibition by the Commission will create a competitive disadvantage for market participants subject to the Commission's rules.
- **Cross-Border Application.** The Commission should apply the Proposed Rules as transaction-level requirements under the CFTC's previously published Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations (the "**Cross-Border Guidance**"),[5] consistent with its statements in the Cross-Border Guidance, to prevent differences in the extraterritorial application of the clearing rules and the margin rules. In addition, the Commission should not apply the Proposed Rules to swaps that are cleared by foreign clearinghouses that have been determined to be in compliance with the CPSS–IOSCO Principles for Financial Market Infrastructures (the "**PFMIs**"),[6] in order to avoid over-margining and a potential flight from such clearinghouses.

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[2] Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, *Margin Requirements for Non-Centrally Cleared Derivatives,* September 2013, available at *http://www.bis.org/publ/bcbs261.pdf*.

[3] Consultation Paper on the Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Art. 11(15) of Regulation (EU) No. 648/2012 published by the European Securities and Markets Authority, the European Banking Authority and the European Insurance and the Occupational Pensions Authority on April 14, 2014.

[4] See *Margin and Capital Requirements for Covered Swap Entities;* Proposed Rule, 79 FED. REG. 573458 at 57374 (September 24, 2014).

[5] 78 *Fed. Reg.* 45292 (July 26, 2013).

[6] Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures,* April 2012, available at *http://www.bis.org/cpmi/publ/d101a.pdf*.

Discussion

I. Calculation of Initial Margin

While it is important to require the posting of margin in amounts that are sufficient to mitigate risk and protect market integrity, requiring the posting and segregation of excess margin as proposed in the rule will have the counterproductive effect of reducing market liquidity at the very times when liquidity is key to the continued functioning of the global financial markets. The BCBS–IOSCO quantitative impact study[7] estimates that using a standardized schedule for calculating initial margin would require the posting and segregation of 11 times more initial margin ("**IM**") than that required under a models-based calculation approach.[8]

Use of models would prevent excessive amounts of liquid assets from being unavailable for use in the markets generally, as sophisticated models are generally better able to determine risk levels of particular transactions and when netting is appropriate. Of course, this does not mean that CSEs should be permitted to use internal models that have not been reviewed by a regulator. However, when one regulator has approved the use of a model, it would be an inefficient use of resources both at the regulator level and at the market participant level to prohibit that model's use by other market participants until it has been reviewed and approved by a second regulator.

For this reason, we recommend that the Commission allow CSEs to submit margin methodology filings as self-executing filings if the methodologies have already been approved on behalf of their affiliates by other regulators, including foreign regulators that have implemented margin regimes consistent with the BCBS–IOSCO Framework. This would further Congress' stated goal, as described in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), that the margin requirements of the Commission, the Prudential Regulators, and the Securities and Exchange Commission be comparable.[9] Such comparability would be undermined if all regulators did not accept the same margin methodologies.

Allowing for automatic approval of margin methodologies that have already been vetted and approved by another regulator would allow affiliated groups to maintain the consistency of their risk management programs—for example, an affiliated swap dealer and security-based swap dealer should be permitted to use the same margin methodology, whether the agency that reviewed the methodology is the Commission or the SEC. Permitting affiliated entities to use the same margin calculation model would further the stated goals of the Internal Business Conduct Standards, which require CSEs to have a risk management program related to swaps activity that is integrated into risk management at the consolidated entity level.[10]

We also recommend that the Commission take steps to facilitate the use of standardized models for the calculation of IM. The use of such models would increase transparency as all market participants will have access to the model's calculation methodologies, and market participants that are not otherwise regulated would not have to rely on their regulated counterparties to produce appropriate models. In addition, the use of standardized models would reduce the potential for disputes among market participants using such a model. Thus, we suggest that the proposed rule be modified to allow that a model that has been developed by industry groups and the Commission or another regulator and has been approved for use by one market participant, such model should be automatically approved for all market participants.

Finally, we recommend that CSEs be permitted to determine IM by netting based on risk sensitivities of their portfolios, instead of based on specific types of asset class. Requiring netting based on asset class could present operational difficulties for CSEs—for example, an OTC swap could have exposure to both rates and foreign exchange risk, and there would be no guidance for the CSE to classify that swap—or to ensure that its counterparties classified the swap in the same manner. Requiring netting based on a rigid set of asset-class based categories could cause market participants to forego swaps that are difficult to categorize, leading to imperfect hedging and increased overall risks in the financial markets.

[7] See BCBS–IOSCO, Second Consultative Document, Margin requirements for non-centrally cleared derivatives (Feb. 2013).

[8] It is also important to note that the BCBS–IOSCO study was conservative in its calculations, given that it assumed an €8 billion standard exposure threshold for financial end-users rather than the Commissions proposed $3 billion threshold.

[9] Commodity Exchange Act § 4s(e)(3)(D)(ii).

[10] 17 CFR 23.600.

II. Material Swaps Exposure Threshold

The Proposed Rules would define MSE as $3 billion in average monthly gross notional amount of swaps, SBS, FX swaps and FX forwards. This represents a decrease of almost 75% from the €8 billion ($11 billion) month-end gross notional amount threshold contained in the BCBS–IOSCO Framework and the European Proposal, thereby substantially expanding the class of U.S. financial end-users that are subject to the IM rules. In the Proposed Rules, the Commission explains that the lower threshold is based on a rough comparison of the amount of margin required for certain cleared swap portfolios against the proposed $65 million IM threshold.[11] Based on this comparison, the Commission expressed concern that the BCBS–IOSCO Framework's €8 billion aggregate gross notional threshold would exclude financial end-users whose IM requirements would exceed the $65 million "minimum collection amount" ("**MCA**") threshold.[12]

We believe that the Proposed Rules diverge from international standards in the use of MCA to calculate MSE. An analysis by the Commission found that financial end-users with total MSE exceeding $3 billion and less than $11 billion would, on average, be required to post more than the $65 million MCA. The Commission reasoned that the Basel Committee intended the MSE threshold to be aligned with the MCA threshold, so they lowered the $11 billion MSE threshold to $3 billion.

However, we consider the two thresholds as distinct in their scope and purposes and believe that the Commission (and the Prudential Regulators) have, in fact, adopted an approach inconsistent with the BCBS–IOSCO Framework, which does not reflect the intent to align these two thresholds.

The IM threshold of $65 million or MCA is a bilateral threshold which is intended to alleviate the operational burdens related to collecting and posting small amounts of IM for all parties subject to the IM requirements. In contrast, the MSE threshold is an entity threshold meant to identify and exclude from the margin requirements those financial end-users whose swaps activity is limited and who do not pose systemic risk to the financial markets. The BCBS–IOSCO Framework defined and provided levels for the two different thresholds and did not relate the two.

The MCA threshold ensures that IM is only exchanged for large exposures between counterparties. For example, two large swaps dealers are not required to exchange IM until their exposures to one another exceed the level where the failure of one entity could deplete the capital of the other entity by this specified amount. As an entirely separate matter, a financial end-user that uses only $3 billion total in non-cleared swaps to hedge risk does not comprise meaningful proportion of the total non-cleared swaps market and thus its hedging costs should not be increased by a minimum IM requirement. Thus, the Basel Committee thought that the $11 billion threshold was the right threshold for imposing initial margin requirements. Thus, given the materially different motivation behind each threshold, the BCBS–IOSCO Framework reflects no need to align them; one exempts small exposures between two covered swaps entities and the other exempts financial end-users with minimal total swaps exposure.

For this reason, we recommend that the Commission revise the MSE threshold of $3 billion, so that it is consistent with the BCBS–IOSCO Framework and the European Proposal of $11 billion. If the Commission fails to make this change, U.S. financial entities that seek to use non-cleared swaps to hedge financial risks will have increased hedging costs and be at a competitive disadvantage to foreign financial entities. Practically speaking, applying a lower MSE threshold to U.S. CSEs will cause harm to both financial end-users based in the United States and those U.S.-based CSEs. U.S. financial end-users that fall under the $11 billion notional threshold but exceed a $3 billion threshold, if they continue to transact with U.S. CSEs, will face higher hedging costs than their foreign counterparts, since those foreign counterparts will not be required to post margin in their trades with foreign swap entities. However, if U.S. financial end-users view the increased margin costs as prohibitive, they could also turn to unregulated entities in order to avoid compliance with the margin rules entirely, or could cease to hedge certain risks, thus increasing overall systemic risk.

We are also concerned that a lower MSE threshold will increase the pro-cyclicality of the margin requirements. In times of stress in the financial markets, volatility rises, which results in increased demand for IM, leading to increased demand and prices for eligible collateral, adding to the stress in the financial markets. The risk

[11] The Prudential Regulators made a similar calculation. 79 *Fed. Reg.* 573458 at 57367 (September 24, 2014).

[12] The BCBS–IOSCO Framework, the European Proposal and the Proposed Rules do not require entities to actually exchange IM collateral until their non-cleared swaps exposures to one another would necessitate $65 million in IM.

of pro-cyclicality will be even greater with a MSE threshold of $3 billion instead of $11 billion. The number of counterparties that will be subject to the margin requirements will be greater with the lower threshold and the population on the cusp that moves above the threshold in any given period will be greater, compounding the pro-cyclicality risk. For this reason, we support ISDA's request for a study to be performed to determine the pro-cyclical effects of using a threshold of $3 billion instead of $11 billion.

The Commission has time to conduct this analysis because the MSE exception will not become relevant until the last compliance date for IM requirements. The Commission, therefore, should defer adoption of a final volume-based exception until after it has also completed a study of the liquidity and cost impact of different exceptions and a related cost-benefit analysis. This approach would be similar to the one taken by the Commission when it adopted its final Swap Dealer *de minimis* exception.

In addition to the foregoing, we recommend that the Commission make several technical clarifications related to the calculation of material swaps exposure. First, the Commission should use its standard definition of "affiliate" to determine whether an entity and its affiliates collectively have material swaps exposure, looking to majority ownership.[13] The definition used by the Commission in the Proposed Rules reaches to a broader universe, stating that control of 25% of an entity's voting securities leads to affiliate status. The Notice of Proposed Rulemaking does not explain this departure, and it creates several issues that the Commission must address either by returning to its original definition or clarifying the Proposed Rules.[14]

The Proposed Rules do not make clear how entities should be treated if they are 25% owned or controlled by more than one entity. For example, should the swap transactions entered into by a joint venture that is 25% controlled by four otherwise unaffiliated financial end-users be taken into account by all four financial end-users? Using the Commission's standard majority-based definition would negate this lack of clarity. If the Commission does not wish to use the standard definition, we recommend that the swaps exposure of affiliates where no majority ownership is present be taken into account only where the swap transactions of the less-than-majority-owned affiliate are guaranteed by its purported affiliate. Otherwise, taking into account exposures of the same entity multiple times would result in financial end-users having to post and collect excessive amounts of margin.

Another technical issue that the Commission must address is how a CSE will identify counterparties that have material swaps exposure. We recommend that the Commission clarify that a CSE may rely on representations by its counterparties as to their material swaps exposure. CSEs should not be responsible for making this calculation, as it is possible that the required information will not be publicly available. Permitting such reliance would be consistent with other Commission regulations, where CSEs are permitted to reasonably rely on counterparty representations as to end-user status[15] and special entity safe harbor status,[16] unless the CSE has reason to believe such representations are incorrect. In addition, CSEs should be permitted to rely on counterparty representations regarding the identity of a financial end-user's affiliates, which is an integral portion of the calculation of material swaps exposure.

III. Re-use of Posted Margin

According to the BCBS–IOSCO Framework,[17] IM collateral that has been posted to a CSE may be re-used by the CSE to finance a hedge position associated with a counterparty's transaction, so long as applicable insolvency law gives the posting counterparty protection from risk of loss of IM in the event the CSE becomes insolvent. If such protections exist, and a financial end-user consents to having its IM reused, then a CSE may re-use IM provided by a financial end-user or another CSE one time to hedge the CSE's exposure to the initial swap transaction.

The reuse of IM collateral can efficiently reduce the cost of non-cleared swaps for U.S. financial end-users, because it allows CSEs to hedge their exposures. For example, a CSE selling non-cleared credit swap protection to a financial end-user counterparty could re-use the IM that it receives from that transaction to buy non-

[13] For example, see the Inter-Affiliate Exemption, 17 CFR 50.52(a)(1)(i).

[14] Note that this is also a departure from the BCBS–IOSCO Framework, which determines material swaps exposure and other thresholds on a consolidated group basis.

[15] For an example, see the *End-User Exception to the Clearing Requirement for Swaps,* 77 FED. REG. 42560 at 42570 (July 19, 2012).

[16] 15 CFR 23.450(d).

[17] See Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, *Margin Requirements for Non-Centrally Cleared Derivatives,* September 2013, available at *http://www.bis.org/publ/bcbs261.pdf*.

cleared credit swap protection from another counterparty. As a result, allowing for the reposting of IM can reduce the liquidity burden on CSEs when they enter into offsetting positions, thereby reducing transaction costs for derivatives users. Moreover, because U.S. bankruptcy laws protect U.S. financial entities in the case of an insolvency of the covered swaps entity, and the collateral may only be reused once for hedging purposes, aligning the Proposed Rules with the BCBS–IOSCO Framework in this respect would not expose U.S. financial entities to any undue risk.

The ability to reuse margin in this manner is particularly important for mid-market non-bank swap dealers like IFM. Such mid-market swap dealers would not reuse margin to engage in proprietary trading or securities lending, but need the ability to use margin to finance hedges directly related to their client-facing trades. Such hedges are beneficial to clients, as they are entered into in order to enable the swap dealer to fulfill its obligations under client-facing transactions. Thus, we believe that a restriction on re-use of posted margin will actually add to market risk. On the other hand, if mid-market swap dealers are permitted to use IM to finance hedge activity, on the condition that the hedge is directly related to the underlying client and the specific trade at hand, then this activity will mitigate transaction risk and market risk.

If mid-market non-bank swap dealers are required to independently post IM to an exchange or counterparty, rather than utilize clients' IM, then such swap dealers would have to borrow from external sources, at a cost, in order to fund the posting of the IM. The cost to the swap dealers, would in turn, be passed on to their counterparties. Although the margin rule is intended to manage systemic risk, an unintended consequence of the rule for mid-market swap dealers and their end-user clients would be that transaction costs will increase. As a result, the Proposed Rules may cause certain market participants to be squeezed out or otherwise unwilling to tie up capital, leaving those market participants with un-hedged risk.

For the forgoing reasons, we suggest that the Commission revise the Proposed Rules to be consistent with the BCBS–IOSCO Framework and permit the reuse of IM under certain circumstances, in particular, where the counterparty consents, applicable insolvency law gives the counterparty protection from risk of loss of IM in the case that the covered third party becomes insolvent, where the hedge is directly related to the underlying client and the specific trade at hand, and where the reuse is not in connection with proprietary trading.

IV. Cross-Border Application

A. The Commission Should Apply the Proposed Rules as Transaction-Level Requirements Under the Cross-Border Guidance

The reach of Dodd-Frank extends not only to activities that take place in the U.S. markets, but also to activities that "have a direct and significant connection with activities in, or effect on, commerce of the United States" or that "contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion" of the Dodd-Frank regulatory regime.[18] Thus, the Commission has the authority to regulate swap transactions outside the United States, but must consider whether such activities meet the thresholds described in Dodd-Frank.

In its Cross-Border Guidance, the Commission divided the major Dodd-Frank requirements into "entity-level" requirements and "transaction-level" requirements.[19] The entity-level requirements are obligations that would be difficult to separate out on a transaction-by-transaction basis, such as risk management, capital adequacy, having a chief compliance officer, and reporting requirements for which registered entities are likely to have set up automated processes. The transaction-level requirements are more easily separated by transaction, and include clearing and execution, trade confirmation, and the external business conduct standards (such as the requirement to provide a daily mark or scenario analysis). The Cross-Border Guidance correctly classified margin as a transaction-level requirement.[20] As with the clearing requirement, it is practicable to separate out transactions which are subject to the margin requirements and transactions which are not.

The fact that the clearing and trade execution requirements were determined to be transaction-level, and not entity-level, requirements should inform the Commission's decision regarding the classification of the margin requirement. Dodd-Frank requires the posting of margin for uncleared swaps to make up for the fact that such swaps are not able to take advantage of the risk mitigation that clearing offers. It

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[18] Commodity Exchange Act § 2(i).
[19] *Cross-Border Guidance,* 78 FED. REG. 45292 at 45331 (July 26, 2013).
[20] *Cross-Border Guidance,* 78 FED. REG. 45292 at 45334 (July 26, 2013).

would be an odd result if the Commission were to determine that the reach of the clearing requirement was not as great as that of the margin requirement, given that both requirements are intended to address counterparty credit risk.

It is also instructive to review the transactions which would be subject to the Proposed Rules, were they treated as an entity-level requirement, in contrast to the transactions that would be subject to the Proposed Rules as a transaction-level requirement. For example, if the Proposed Rules were treated as an entity-level requirement, they would apply (with substituted compliance available only if the Commission so determined) to transactions between non-U.S. CSEs and their non-U.S. counterparties, whether or not those non-U.S. counterparties were affiliated with or guaranteed by a U.S. person.[21]

It is difficult to conclude that transactions between two non-U.S. entities would have the direct and significant effect on U.S. commerce necessary to invoke the Commission's authority on such transactions. While, for example, a non-U.S. swap dealer's failure at the entity level to maintain adequate capital or to have in place a proper risk management policy could have a significant impact on its U.S. counterparties, thus necessitating the application of those rules at the entity level, a non-U.S. swap dealer's failure to margin transactions with its non-U.S. counterparties should not have a similar direct and significant impact as long as the swap dealer is otherwise complying with the entity-level requirements for capital adequacy and risk management.

B. Swaps that Are Cleared by Foreign Clearinghouses that Have Been Determined To Be in Compliance with the PFMIs Should Not Be Subject to the Proposed Rules

In a number of circumstances, the Commission has acknowledged that U.S. parties may satisfy their clearing obligations by using clearing organizations that are compliant with the PFMIs. For example, in the Clearing Exemption for Swaps Between Certain Affiliated Entities (the "**Inter-Affiliate Exemption**"),[22] the Commission requires electing affiliates to clear all outward-facing swaps on a registered DCO or a clearinghouse that is subject to supervision by appropriate government authorities in the clearinghouse's home country and has been assessed to be in compliance with the PFMIs.[23] Similarly, all contracts that an FBOT makes available for trading by direct access in the United States are subject to a clearing requirement. This clearing requirement can be satisfied either by the FBOT's clearing through a registered DCO or through another clearing organization that is in good regulatory standing in its home country and observes the PFMIs.[24]

Given that Principle 6 of the PFMIs includes margin requirements very similar to the requirements of the Proposed Rules,[25] the Commission should not subject parties that elect to use such clearing organizations to additional margin requirements. The costs of such excessive margining would clearly outweigh its benefits. First, requiring the posting of margin in addition to that required by the related clearing organization would result in an unnecessary drain on liquidity in markets. And more importantly, counterparties could determine that the costs of clearing (including posting the margin required by such clearing agencies) in addition to posting bilateral margin are too great and turn to uncleared swaps in order to avoid the additional costs. This would result in increased risk to the financial system, rather than avoiding risk in accordance with the goals of Dodd-Frank.

V. Conclusion

INTL FCStone and IFM generally support the Proposed Margin Rules and are grateful that the Commission is again consulting the public on the implementation of margins for uncleared swaps. IFM welcomes the progress that has been made on this issue but urges the Commission to reconsider its position on the threshold for material swaps exposure, rehypothecation, the calculation of initial margin and the application of the Proposed Rules to cross-border transactions as described in this letter.

[21] 79 *Fed. Reg.* 59917.
[22] 78 *Fed. Reg.* 21750 (April 11, 2013).
[23] 17 CFR 50.52(b)(4)(B).
[24] 17 CFR 48.7(d).
[25] Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures,* April 2012, available at *http://www.bis.org/cpmi/publ/d101a.pdf*.

If you have any questions about any of the comments outlined in this letter, please do not hesitate contact me for more information at 212.379.5449 and e-mail at *Catherine.Napolitano@intlfcstone.com*.

Sincerely,

CATHERINE E. NAPOLITANO,
Deputy General Counsel.

REAUTHORIZING THE COMMODITY FUTURES TRADING COMMISSION
(MARKET PARTICIPANT VIEWS)

WEDNESDAY, MARCH 25, 2015

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY, AND CREDIT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 1:34 p.m., in Room 1300 of the Longworth House Office Building, Hon. Austin Scott of Georgia [Chairman of the Subcommittee] presiding.

Members present: Representatives Austin Scott of Georgia, Lucas, LaMalfa, Davis, Emmer, Conaway (*ex officio*), David Scott of Georgia, Vela, Maloney, Kirkpatrick, and Aguilar.

Staff present: Caleb Crosswhite, Haley Graves, Jackie Barber, Jessica Carter, Paul Balzano, Faisal Siddiqui, John Konya, Matthew MacKenzie, and Nicole Scott.

OPENING STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

The CHAIRMAN. Well, good afternoon. This hearing of the Subcommittee on Commodity Exchanges, Energy, and Credit regarding reauthorization of the CTFC as it relates to market participants' views, will come to order. Thank you for joining us for our second meeting of the Commodity Exchanges, Energy, and Credit Subcommittee of the House Committee on Agriculture. Yesterday we kicked off the work of this new Subcommittee by hearing from several representatives from the community of derivatives and end-users on their thoughts regarding the CFTC reauthorization process this Committee will be undertaking in the days ahead.

Today we will continue that examination with a focus on perspectives from the futures and swap marketplaces. We are fortunate to be joined by a panel of distinguished witnesses, who are here to share their perspectives as derivatives market participants. The industry is well represented today by two of the largest derivative exchanges, a key self-regulatory organization, and two important industry trade associations. We hope to come away with a greater understanding of the challenges that each of them face.

Derivatives markets have changed in the 5 years since the passage of Dodd-Frank, both because of and in response to the new rules written by the Commission. Many of the witnesses before us today have seen daunting changes in regulatory burdens and busi-

ness practices, perhaps none more so than Mr. Bernardo, who testified in front of our Committee a little over 4 years ago, in February of 2011. At that time, the rules governing his soon to be SEF had not yet been written. They wouldn't be proposed until June of 2011, and they were not finalized until August of 2013.

In the 18 months since the rules were finalized, the CFTC still has not finalized the registration of a single SEF. Mr. Bernardo has seen the entire process of creating the SEF rules structure rise, and set—and yet he is still facing considerable uncertainty about the business he operates.

Likewise, the further into implementation we get, the more cross-border jurisdictional issues seem to arise. Today we will hear testimony from five witnesses, four of whom will mention the confusion and difficulty they are facing following competing, often conflicting, rules for these international markets. The continuing uncertainty and ambiguity in the rules, compounded by the sweeping nature of these regulatory changes, pose challenges for the witnesses before us today and their customers, the end-users who rely on access to derivatives markets.

My goal throughout this process is to ensure that we have a healthy balance between market integrity and market access. Derivatives markets exist for those who have a need to hedge. Hedgers need markets that are safe, but also need markets with affordable execution, available counterparties, and consistent liquidity. This Subcommittee will continue to look for that healthy balance. Thank you to the witnesses for appearing before you today. We look forward to hearing your perspective on these issues, and I appreciate the time and effort that you have put forward to be here.

[The prepared statement of Mr. Austin Scott of Georgia follows:]

PREPARED STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Good afternoon. Thank you for joining us for our second meeting of the Commodity Exchanges, Energy, and Credit Subcommittee of the House Committee on Agriculture.

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At that time, the rules governing his soon-to-be SEF had not yet been written. They wouldn't be proposed until June of 2011, and they were not finalized until August of 2013. In the 18 months since the rules were finalized, the CFTC still has not finalized the registration of a single SEF. Mr. Bernardo has seen the entire process of creating the SEF rule structure rise and set, and yet he is still facing considerable uncertainty about the business he operates.

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four of who will mention the confusion and difficulty they are facing following competing, often conflicting, rules for these international markets.

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Thank you to the witnesses for appearing before us today. We look forward to hearing your perspectives on these issues and appreciate the time and effort you've put forward to be here.

With that, I'll recognize our Ranking Member, Mr. Scott, for any remarks he'd like to make.

The CHAIRMAN. With that, I will recognize our Ranking Member, Mr. Scott, for any comments that he may have.

OPENING STATEMENT OF HON. DAVID SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Mr. DAVID SCOTT of Georgia. Thank you, Chairman Scott, and it is indeed a pleasure to have these distinguished witnesses before us. As we all know, derivatives are just an extraordinarily exploding growth sector of our world economy. It is right up there now around $700 trillion worth of the world's economy. It is a very complex, complicated issue.

There are many issues that we need to address as we go through this reauthorization. Paramount, of course, is to make sure that the CFTC has adequate funding to do the job. If that is not in place, then we create another series of problems that prohibit us from having a clear vision of where we need to go. So I am pleased that we are continuing a strong series of hearings to discuss the reauthorization of the Commodity Exchange Act.

And as I mentioned yesterday, in the last Congress we put together a very good bill, a very robust bipartisan package, and that was H.R. 4413. Unfortunately, it passed out of here by voice vote, it passed on the House floor, but the Senate did not take that up. And we refer to it as, of course, the Customer Protection and End User Relief Act.

It is common-sense legislation, and we need to continue to move in that direction with new legislation as quickly as we can. So this year we are going to put forth a bill that basically mirrors much of what we had in H.R. 4413, and yesterday I highlighted some of the essential points that related to our end-users, and the critical component of providing much-needed clarity, and easing some of the unnecessary burdens, which include reporting requirements.

And it is very important that we realize that many of our end-users, most of which had nothing to do with the financial meltdown, and certainly we need to look with a very clear eye to make sure that we are not putting them at a competitive disadvantage without understanding that differentiation. So today I am pleased that we have representatives of our market participants, very fine exchanges that we have worked with over the years, and I am confident that we will have a very productive discussion regarding the reauthorization of the Commodities Exchange Act.

So, Mr. Chairman, I look forward to hearing from our witnesses regarding their thoughts on last year's bill, any improvements that

you think we can make, going forward, that we can add to what we did with H.R. 4413, areas of interest that may require further examination. You all are market participants. You are the ones that have to make this work. So we can make the law, but you are the ones that have to make it work, and so we are very interested in having a very candid, forthright conversation, two-way with you, as to how we can certainly improve the situation.

There have been points of concern that have arisen, to include personnel location tests, the European Union's recognition of U.S. clearinghouses, the U.S. recognition of foreign clearinghouses, cross-border guidance, and the *U.S. person* definition, to mention certainly just a few. And so, Mr. Chairman, I was very pleased when we dealt with many of these issues in H.R. 4413, and I am very confident that we will address them again in a very bipartisan issue.

And finally, Mr. Chairman, I want to re-emphasize my call, that we really strengthen the CFTC, and give the agency the adequate funding that they need, and support that is required in order for the CFTC to fulfill its mandated mission, which is to protect market users and their funds, consumers, and the public from manipulation and abusive practices related to derivatives.

We have an awful lot of issues that are still out there: cross-border, to make sure that we are doing the proper thing. And the CFTC is that arbiter there. It is very important that, where possible, where we have to make joint rules between CFTC and the SEC that that go forward. So we have quite a bit on our plate. We are looking forward to a very interesting hearing. Thank you very much for coming, and Mr. Chairman, I yield back.

The CHAIRMAN. Thank you, Mr. Scott. The chair would request that other Members submit their opening statements for the record so the witnesses may begin their testimony, and to ensure that there is ample time for questions. The chair would like to remind Members that they will be recognized for questioning in order of seniority for Members who were present at the start of the hearing. After that, Members will be recognized in the order of their arrival. I appreciate Members understanding. Witnesses are reminded to limit their oral presentations to 5 minutes. All written statements will be included in the record.

I would like to welcome our witnesses to the table, Mr. Terrence Duffy, Executive Chairman and President of the CME Group, Chicago, Illinois, Mr. Benjamin Jackson, President and Chief Operative Officer, ICE Futures U.S., New York, New York, Mr. Daniel Roth, President and CEO, National Futures Association, Chicago, Illinois, Mr. Gerald F. Corcoran, Chairman of the Board and Chief Executive Officer, R.J. O'Brien and Associations, LLC, Chicago, Illinois, on behalf of the Futures Industry Association, and Mr. Shawn Bernardo, Chief Executive Officer, tpSEF, Tullett Prebon, Jersey City, New Jersey, on behalf of the Wholesale Market Brokers Association of Americas.

Mr. Duffy, please begin when you are ready.

STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, CHICAGO, IL

Mr. DUFFY. Thank you very much, Chairman Scott, Ranking Member Scott, and Members of the Committee, for allowing the CME the opportunity to present our perspective on the CFTC reauthorization. I have addressed several things in my written testimony, but today I have one overriding issue. It is among the most critical facing the U.S. derivatives markets today. It can be summed up in just one word, and Chairman—and Mr. Scott said it a moment ago, which is equivalence.

Under European law, U.S. clearinghouses and exchanges, like CME, must be recognized by their European regulations. This recognition can only happen if the European Commission first determines that the regulations in the United States are equivalent to European Union regulations. Without these actions, European clearing firms, and market participants, will be subject to a prohibitive cost if they clear or trade in the United States, or they may be denied access to U.S. clearinghouses and exchanges altogether.

This could harm U.S. clearinghouses and exchanges competitively. It would also harm both U.S. and EU market participants. It would drive down participation in the U.S. futures markets. It would reduce liquidity. It would impede the ability of farmers, ranchers, and other U.S. and EU businesses to conduct critical risk management needs. Because no prudent business wants to be caught in a regulatory game of chicken, we are already seeing firms taking steps to consider alternatives outside of the United States.

After more than 2 years of negotiation and delays, the European Union has refused to grant the United States equivalence. Since his arrival at the CTFC, Chairman Timothy Massad has been a tremendous leader in working towards a solution, a solution that avoids market disruption, and affords U.S. and foreign-based markets equal flexibility. Yet the European Union continues to hold up the U.S. equivalence determination over a single issue, our margining standards, while, at the same time, they have approved other countries, including Singapore, which uses the same margining standards we do in the United States. The United States should not be required to have identical margining standards to the EU. The specific U.S. margin standards in question are an important component, but not the only component, of a robust regulatory structure under the CFTC's oversight.

What is puzzling is that the U.S. rules generally require equal, if not more, margin to be posted with clearinghouses than they do in the European Union. We call upon the European Commission to take a balanced approach. It should allow the United States and Europe to recognize each other's regulatory regimes, including margin rules. Time is of the essence.

On June 16 of this year, if the U.S. is not granted equivalence, U.S. clearinghouses will not be deemed qualified central counterparties under European law. As a result, customers will be subject to significant and inappropriate capital cost if they are to use U.S. clearinghouses. Furthermore, a European clearing mandate, which is similar to our Dodd-Frank mandate, will also go into effect in the fourth quarter of this year. Without the U.S. being recognized, Eu-

ropean market participants will be prohibited from using U.S. clearinghouses to clear mandated derivatives.

Today the CFTC rules and policies grant European-based foreign boards of trade and clearinghouses full access to the U.S. marketplace. At the same time, the CFTC has many tools at its disposal to deny such generous access. For example, the CFTC could terminate the no action relief under which foreign boards of trade are currently operating in the U.S. I hope this does not prove necessary, but all options must be considered at this time. We urge this Committee to take any and all appropriate actions to support the CFTC's position and reach a solution as soon as possible.

There is one other issue that I would like to mention today, and that is the threat to how commercial market participants manage their risk. The position on this proposal that is currently pending before the CFTC would impose overly narrow restrictions on the hedging and on commercial market participants. It would limit them to a narrow list of transactions. This approach would prevent businesses from continuing their traditional hedging operations. It would introduce unnecessary risk and cost, which could ultimately fall upon the consumer.

There is a simple solution, however. The rule should be amended to accommodate all reasonable commercial risk reduction strategies that satisfies the statutory criteria. This flexible approach would recognize traditional hedging practices. It would also prevent the Commission from needlessly tying up its limited resources.

I want to thank the Committee for its time and attention today, and look forward to answering your questions.

[The prepared statement of Mr. Duffy follows:]

PREPARED STATEMENT OF HON. TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN AND PRESIDENT, CME GROUP, CHICAGO, IL

Good morning, Chairman Scott and Ranking Member Scott. I am Terry Duffy, Executive Chairman and President of CME Group.[1] Thank you for the opportunity to offer market perspectives on the future of the Commodity Futures Trading Commission ("CFTC" or "Agency"). As this Committee considers reauthorization of the Agency, I would like to highlight five critical issues to the future of the Agency: EU equivalency standards, position limits, agency funding, customer protection, and central counterparty risk.

EU Equivalency Standards

Among the most critical issues facing the Commission today is the potential for the United States to be denied status as a country whose regulations are equivalent to Europe's. CME operates futures exchanges, clearinghouses and reporting facilities in the U.S. and UK, and our U.S. futures products reach over 150 jurisdictions across the globe. Cross-border access is a core part of our global business strategy. CME has long been an unabashed supporter of mutual recognition regimes that (i) eliminate legal uncertainty, (ii) allow cross-border markets to continue operating without actual or threatened disruption and (iii) afford U.S.-based and foreign-based markets and market participants equal flexibility. Historically, both the U.S. and

[1] CME Group Inc. is the holding company for four exchanges, CME, the Board of Trade of the City of Chicago Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

EU have mutually recognized each other's regulatory regimes to promote cross-border access.

Recently, however, the European Commission has taken a different approach. Under European law, U.S. clearinghouses and exchanges—like CME—must first be recognized by European regulators in order to be treated the same as EU clearinghouses and exchanges. The European Commission is conditioning its recognition of U.S. derivatives laws as equivalent to European law on demands for harmful regulatory changes by the U.S. that would impose competitive burdens on U.S., but not EU, clearinghouses and exchanges, and would harm both U.S. and EU market participants.

After more than 2 years of negotiation and delay, the EU still has refused to grant U.S. equivalence. Since his arrival at the CFTC, Chairman Massad has been a tremendous leader in working toward a solution that avoids market disruption and affords U.S. and foreign-based markets equal flexibility. Yet, the EU continues to hold up the U.S. equivalence determination over the single issue of differing initial margining standards for clearinghouses. The specific U.S. margin standards in question are an important component, but not the only component, of a robust regulatory structure under the CFTC's oversight. And even considering just this component of the margin standards, the U.S. rules generally require equal, if not more, margin to be posted with clearinghouses to offset exposures than is the case under the EU rules. Nonetheless, the European Commission has thus far insisted that the U.S. accept EU margin requirements, and has not agreed to any compromise. They have rejected a solution that would allow the U.S. and EU to apply whichever margin requirement is higher, rather than imposing the EU standards on the U.S., or *vice-versa.*

By contrast, the European Commission recently granted "equivalent" status to several jurisdictions in Asia, including Singapore, which has the same margin regime as the U.S. Treating the U.S. as not equivalent when the European Commission has deemed the same margin requirements equivalent in Singapore is inconsistent and should be unacceptable to the U.S.

In stark contrast to the EU approach, U.S. regulations currently allow European based futures markets full access to U.S. market participants. Today, a foreign board of trade may provide direct electronic access to persons located in the U.S. by registering with the CFTC as a Foreign Board of Trade ("FBOT"). The CFTC grants FBOT status if it finds that the board of trade and its clearinghouse are subject to comparable regulation in its home jurisdiction. Although the CFTC has not yet approved all FBOT applications, it has granted no-action relief to several foreign boards of trade with pending FBOT applications, permitting them to continue to access U.S. market participants without disruption until the CFTC completes its review of the FBOT applications.

The European Commission's discriminatory approach to U.S. access to EU markets is creating significant competitive disadvantages for U.S. markets and the participants that use those markets. Without an EU recognition of equivalence, U.S. clearinghouses will not be able to clear EU-mandated derivatives. As market participants need to prepare for the impending effectiveness of Europe's swaps clearing mandate by year-end, already we are seeing European clearing members and other market participants taking steps to consider alternatives to U.S. exchanges and clearinghouses.

This regulatory game of "chicken" also is causing disruptions to U.S. futures markets because, without equivalence, the cost of clearing futures on U.S. markets will increase significantly on June 15, 2015. Under EU laws, non-EU clearinghouses must be recognized as "qualified central counterparties" or QCCPs by June 15. To be QCCP eligible, the European Commission must determine that the clearing regulations in the applicable non-EU country are "equivalent" to EU regulation. Accordingly, without an EU equivalence determination by June 15, U.S. clearinghouses, like CME, will no longer be treated as "QCCPs" from a capital perspective, significantly increasing the costs for European clearing firms to use U.S. clearinghouses.

The EU's resistance to recognizing U.S. exchanges as equivalent also has driven commercial participants away from U.S. exchanges because their trades are treated as OTC trades unless they are executed on an exchange in an equivalent jurisdiction. Commercial end-users appropriately want to avoid the extra regulatory obligations that come with being deemed "NFC+" entities in Europe—a byproduct of trading a certain amount of non-hedging OTC derivatives—so they are leaving U.S. exchanges or reducing their trading on U.S. exchanges until U.S. equivalence is granted. Make no mistake that a continued decrease in participation in U.S. futures products will harm both EU and U.S. market participants, reducing liquidity and impeding the ability of farmers, ranchers and other U.S. and EU businesses to conduct prudent risk management.

Insisting on only the EU margin standards makes no sense when principles governing margin have already been issued by global standard setters, and have been implemented by the U.S. and jurisdictions throughout the world. The U.S. should not be the only nation that is required to have identical margin standards to the EU. Time is of the essence. It is imperative that the European Commission take a balanced approach and allow the U.S. and Europe to recognize each other's regulatory regimes, including margin standards, equally—and soon. If the U.S. continues to be excluded from the European marketplace, the CFTC has many tools at its disposal to deny the generous access to U.S. markets that foreign boards of trade and clearinghouses now have. Indeed, it would be entirely logical for the CFTC to terminate the no-action relief under which FBOTs in Europe are currently operating until the EU recognizes U.S. derivatives regulations as equivalent and U.S. clearinghouses as QCCPs. I hope this does not prove necessary, but all options must be considered. We urge this Committee to take any and all appropriate actions to support the CFTC's position and reach a solution as soon as possible.

Position Limits

Perhaps no other post-Dodd-Frank rulemaking has been more controversial than the Agency's position limits proposal. The Agency currently is considering public comments on rules that were re-proposed at the end of 2013. Despite a total of over 4 years of public comments, four notices of proposed rulemakings, and one final rule that was vacated by a Federal court, the industry is still awaiting answers to some of the most fundamental questions regarding how a Federal position limits regime under Dodd-Frank will work.

Significantly, the currently-proposed *bona fide* hedging exemption would force a dramatic step back from historical market practices by disallowing many reasonable commercial hedging strategies. There is no evidence that Congress intended for the Agency to make it more difficult through position limits rules for farmers, ranchers, and other commercial end-users to hedge their price risks. By limiting the exemption to a rigid and narrow list of enumerated hedges, the Agency's proposal threatens to inject considerable risk into commercial operations. Rather than refuse to give commercial end-users the latitude to continue using reasonable commercial hedging practices for fear that a few bad actors could abuse the system, the Agency should rely on its anti-evasion powers to enforce the limits. CME supports allowing exchanges to administer non-enumerated hedge exemptions that meet the statutory criteria. Such legislation would alleviate the Agency from needlessly tying up its limited resources responding to requests for non-enumerated hedge exemptions.

Several other critical points remain in flux. We encourage this Committee to carefully consider the following issues:

- It remains to be seen which deliverable supply estimates the Agency will use as a baseline for setting Federal spot-month limits. CME continues to advocate for using the most up-to-date deliverable supply estimates that are available from a physical delivery market. To date, CME is the only U.S. exchange to have provided the Agency with current deliverable supply estimates for the core referenced futures contracts that would be covered by the Agency's re-proposal. The Agency must identify for the public the deliverable supply estimate baseline it will use prior to finalizing any Federal limits, and require all exchanges to use those same deliverable supply estimates for purposes of establishing exchange-set limits.
- Consistent with past policy, the Agency should not impose spot month limits based on an absolutist approach to the 25% of deliverable supply formula across all referenced contracts. No sound economic theory or analysis supports such a uniform approach. Rather, the Agency should use 25% of deliverable supply as a ceiling and work with the exchange(s) listing the physical-delivery benchmark contract to set the Federal spot-month level below this ceiling on a contract-by-contract basis, recognizing the unique market characteristics of each commodity that is traded.
- Limits for physical delivery and cash-settled "look-alike" contracts should be equal for the same underlying commodity. The proposed conditional limit exemption for cash-settled contracts threatens to drain liquidity away from the physical delivery markets to the cash-settled markets during the spot month as contracts approach delivery, thus causing harm to the price discovery process and opening the door to potential market misconduct. The Agency should not seek to artificially tip the scale in favor of cash-settled markets and increase the risk of possible price manipulation or distortion.
- Position accountability levels should apply in lieu of hard limits outside of the spot month for non-legacy agricultural commodity derivatives. Nothing in the

Agency's statute or any legislative history should foreclose the possibility of using this more flexible position accountability approach in the out months as a reasonable alternative to Federal hard cap limits. Such an approach would better serve market integrity and protect the price discovery process in the out months when diminished liquidity can have a severe negative impact. Exchanges have successfully relied upon accountability levels for decades to safeguard against market congestion and abusive trading practices. Based on this experience, exchanges are well positioned to partner with the Agency to administer a Federal position accountability program, thus preventing any further drain on the Agency's limited resources.

Agency Funding

The Administration's FY 2016 budget proposal requested a $72 million increase in Agency funding over the current fiscal year. The Administration also signaled continued support for legislative efforts to fund the Agency's budget through "user fees" assessed on transactions that the Agency oversees. While CME supports sufficient funding for the Agency to carry out its critical legislative mandates, we do not support securing this funding through the imposition of what amounts to an additional tax on the backs of America's farmers, ranchers, and other end-users who hedge commodity price risks. As we all know, American consumers ultimately are the ones to pay the higher price when it costs more for producers to hedge.

In order to fully fund the CFTC at the requested level, the Administration's proposal mistakenly assumes that a user fee will not chase trading volume away to lower cost jurisdictions. This assumption is unrealistic, particularly in an age of electronic, interconnected markets where participants can and will shift their business. As financial reform legislation continues to be implemented around the world, CME is concerned that ample reasons already exist to support the flight of liquidity from U.S. markets overseas. Less liquidity at home will lead to a diminished price discovery process. Now more than ever, we believe it would be shortsighted for Congress to artificially tip the scale in favor of other jurisdictions by imposing a transaction tax to fund the CFTC.

Customer Protections

SRO Structure

CME continues to reject calls to dismantle the system of self-regulatory organization ("SRO") oversight that has governed the U.S. futures markets for decades. Today, the SRO construct no longer consists solely of a single entity governed by its members regulating its members; rather, exchanges, most of which are public companies, oversee the market-related activities of all of their participants—members and non-members—subject to corollary oversight by the CFTC and National Futures Association ("NFA"). An exchange's ground-floor vantage point into its markets provides a unique level of expertise that the CFTC alone is not equipped to have. This is not to suggest that hard lessons have not been learned in recent years and there is no room for improvement. To the contrary, CME, along with the NFA and other exchanges, have buttressed systems over the past 2 years to better detect and deter another MF Global or Peregrine Financial situation from occurring.

The financial incentives of SROs also benefit the safety and soundness of the markets which they oversee. Effective SRO regulation is necessary to ensure that an exchange clearinghouse that is required to have "skin in the game" does not have to tap into these reserve funds in the event of a member default, which would in turn harm shareholders. To accomplish this, exchanges devote substantial resources to their self-regulatory responsibilities. CME alone spends more than $40 million annually carrying out its regulatory functions, which includes employing over 200 financial regulatory, IT, and surveillance professionals to monitor its markets and detect financial misconduct before it occurs.

Residual Interest

CME remains fully committed to protecting Futures Commission Merchants ("FCM") customers against the full range of wrongful FCM misconduct that may result in loss of customer funds. In 2012, the CFTC proposed a rule that, under a phased-in schedule, would have required an FCM to maintain *at all times* a sufficient amount of its own funds ("residual interest") in customer-segregated accounts to equal or exceed the total amount of its customers' margin deficiencies. As noted in prior testimony, no system exists to enable an FCM to continuously and accurately calculate customer margin deficiencies in real time. The net result would be that either FCMs would be forced to post their own collateral into customer accounts, or customers would be forced to over-collateralize their margin accounts at all times. Neither outcome constitutes an efficient use of capital and would effec-

tively render derivatives markets prohibitively expensive and unusable for end-users.

We applaud the CFTC for moving away from the "at all times" requirement and further eliminating last week the automatic acceleration in 2018 of the posting deadline to a time occurring earlier than 6:00 p.m. the day of settlement. This Committee codified in the Reauthorization Bill passed by the House last Congress a provision that would permanently establish the residual interest posting deadline at the end of each business day, calculated as of the close of business the previous business day. CME again supports the inclusion of such a provision in any Reauthorization Bill considered by the Committee during the current Congress.

Central Counterparty Risk

Clearinghouse Capital Contributions

Much attention recently has been paid to how much capital a clearinghouse such as CME should contribute to manage a default by one or more of its clearing members. We could not agree more with the general principles on this topic outlined by CFTC Chairman Massad 2 weeks ago in his keynote address to the annual meeting of the Futures Industry Association. There, Chairman Massad recognized that any discussion of clearinghouse capital contributions must take stock of the purpose clearinghouses are meant to serve—risk management—*versus* the purpose served by clearing members—trading, lending, or other types of risk creation. In other words, risk is concentrated not at the clearinghouse, but rather within a clearing member through the exposures it brings to the clearinghouse.

CME recognizes the role of clearinghouse capital in managing risk. As a systemically important clearinghouse, CME must have financial resources available that are sufficient to meet its obligations to all of its clearing members despite a default by the two clearing members that could create the largest potential loss at any point in time. CME can meet this standard through any allocation of initial margin, its own capital, and clearing member default fund contributions. In making this allocation, CME has provided a larger capital contribution to its waterfall to date than any of its U.S. competitors. CME commits to using its capital contribution, in a first loss position, before any non-defaulted clearing member assets.

By contributing first-loss capital to the waterfall, CME has a greater incentive to prudently manage its clearing members' concentrations. However, CME also understands that arbitrary, excessively large clearinghouse capital contributions introduce negative incentives. For example, if CME were to increase its capital contribution to the CME waterfall to cover the shortfall for the largest potential defaulting clearing member, this would allow clearing members to increase their risk exposures by over 40% for the same level of default fund contributions they make today, with CME subsidizing the additional risk with its own funding. As a result, CME's increased contribution would significantly diminish the incentives of clearing members to manage their own risk by maintaining balanced portfolios, manage the risks of their clients and actively participate in the default management process to ensure their default fund contributions are not used in a fellow clearing member default.

Recent history illustrated for us the moral hazard issues created by lenders repackaging and offloading the risk of their loans via securitizations. By separating the risk from the responsibility of bearing that risk in the event of the loans not being repaid, these lenders lacked incentive to conduct appropriate due diligence on their loans. We should learn from the mistakes of securitization lenders by continuing to balance clearinghouse capital contributions in a manner that ensures that market participants are sufficiently incentivized to manage the risks they create.

U.S. Regulatory Oversight of Clearinghouses

Due to the critical role clearinghouses like CME play in mitigating systemic risk to the U.S. economy, certain market participants recently have called upon the Financial Stability Oversight Council ("FSOC") to play a greater oversight role. Congress, however, should resist the urge to heed these calls by injecting FSOC into an existing regulatory framework that does not need "fixing." The CFTC and SEC already provide robust oversight of U.S. clearinghouses. Furthermore, the rules and regulations already imposed by these agencies facilitate adherence to many of the principles that critics mistakenly complain are currently absent from clearinghouse governance.

First, clearinghouses, including CME, are extremely transparent to their clearing members, regulators, and the general public. Clearinghouses post their rulebooks, rule submissions, and written policies and procedures online. Clearinghouses publish public reports detailing how they comply with the international "Principles for Financial Market Infrastructures," as well as participate in a standardized financial reporting structure through the Fed's Payments Risk Committee that allows clear-

ing members to compare among multiple clearinghouses the financial resources, collateral, central counterparty investments, and back-testing and stress-testing results of each clearinghouse. With respect to stress testing specifically, additional detailed reports already are submitted to each clearinghouse's risk committee and regulators for purposes of providing even greater transparency into the resiliency of each clearinghouse's financial safeguards.

Next, clearinghouse rules such as those of CME detail precisely what financial obligations may be incurred, now and in the future, by clearing members in the form of margin payments, default fund requirements, and assessments. These rules also detail a clearinghouse's capital contributions and waterfall structures and any changes to these rules are subject to a transparent review process that is open to the public. Clearing members can rest assured that the current regulatory framework provides certainty as to how much capital is required of each market participant and the order in which these resources will be used to cure any deficiency in a clearinghouse's funding under a clearing member default scenario.

Last, current regulations already require CME and other systemically important clearinghouses to prepare credible recovery and wind-down plans in the event that the viability of the clearinghouse is threatened. While CME believes that its existing default management framework is sufficient to handle multiple concurrent member defaults under normal circumstances, we appreciate the value of worst-case-scenario planning given the importance of our services. We are actively working with our Clearing House Risk Committee, clearing members, and regulators to enhance our plans that are designed to continue CME's clearing operations, and if needed, conduct an orderly wind-down, without causing systemic risk to the larger financial system. As every clearinghouse's risk profile and risk management framework is unique and the facts and circumstances of any doomsday scenario could vary widely, CME believes it would be imprudent for regulators or Congress to impose a one-size-fits-all approach to these plans or stress tests.

Conclusion

We appreciate the Committee's consideration of the views expressed in this testimony. We stand ready to assist the Committee as a resource in finalizing legislation that ensures the U.S. will remain a competitive player in the global derivatives marketplace while enhancing the safety and soundness of futures and derivatives markets at home through a principles-based CFTC regulatory regime.

The CHAIRMAN. Thank you. Mr. Jackson?

STATEMENT OF BENJAMIN JACKSON, PRESIDENT AND CHIEF OPERATING OFFICER, ICE FUTURES U.S., NEW YORK, NY

Mr. JACKSON. Chairman Scott, Ranking Member Scott, I am Ben Jackson, President and COO of ICE Futures U.S. I appreciate the opportunity to discuss the reauthorization of the Commodity Futures Trading Commission, and I am going to comment today on two specific topics. First, ICE Futures U.S., and our self-regulatory functions. As background, ICE Futures U.S. is a designated contract market owned by the IntercontinentalExchange, which is the leading global network of regulated exchanges and central counterparty clearinghouses for financial and commodity markets. ICE Future U.S. has a strong history of overseeing position limits, accountability levels, and exemption requests.

Our market regulation teams employ decades of surveillance and compliance expertise in working with the derivatives markets and the derivatives markets participants that they oversee. This extensive direct experience has guided our self-regulatory functions. In particular, the rules and procedures developed and used by our exchange to perform this important function were designed to incorporate the specific needs and differing practices of the commercial participants in each of our markets as those needs and practices have developed over time. In revisiting the CEA, the Committee should encourage the CFTC to re-examine the position limit proposal, and in particular the effects of narrowing the definition of

what qualifies as a *bona fide hedge,* and the move toward hard position limits in the non-spot month.

For administering hedge exemptions, given the CFTC's constrained resources, and the significant time and resources that such an undertaking would require, we believe that the existing current structure reflects an efficient allocation of resources that ensures commercial market participants will be able to continue to hedge their risks in a timely manner.

In regard to position limits in the non-spot months, the current accountability regime has proven to be effective at balancing liquidity in nearby month expiries and future month expiries. We believe that the current regime is effective, from a resource standpoint, and has proved to result in well-functioning markets. Therefore, the current regulatory regime, which is overseen by the CFTC, and incorporates rules subject to CFTC review, should remain in effect.

The second topic I want to touch on is where we are, in my view, on global financial reform efforts. Over the past 2 years, regulators in the United States and Europe have been working to address conflicts in the two major financial reform efforts, Dodd-Frank in the U.S., and EMIR in Europe. ICE Futures U.S. appreciates the hard work that the CFTC and its staff, as well as their counterparts in Europe, are putting into achieving true equivalence. The derivatives markets are global, and in addressing these conflicts, we encourage regulators to reach this equivalence. Widely varying rules will only serve to increase complexity for the people that use our markets every day.

The CFTC has historically relied on foreign regulators to regulate foreign transactions, and worked with regulators to adopt common principles that all regulated markets should adopt. European regulators took a similar approach to U.S. markets. This approach was very successful, as it led to a greater harmonization of regulation, yet allowed foreign regulators to oversee their institutions. We strongly encourage a return to this approach.

In conclusion, I would like to note our appreciation of Chairman Massad, and the CFTC's efforts to address many of the issues that I have noted today through re-examining some of the rules affecting the futures markets. We also appreciate the efforts of this Committee to re-examine the CEA, and the impact of Dodd-Frank. Thank you.

[The prepared statement of Mr. Jackson follows:]

PREPARED STATEMENT OF BENJAMIN JACKSON, PRESIDENT AND CHIEF OPERATING OFFICER, ICE FUTURES U.S., NEW YORK, NY

Chairman Scott, Ranking Member Scott, I am Ben Jackson, President and Chief Operating Officer of ICE Futures U.S. I appreciate the opportunity to discuss the reauthorization of the Commodity Futures Trading Commission (CFTC).

Over the past 5 years, ICE Futures U.S. and other derivatives markets participants have been implementing U.S. and global financial reform rules. While the overall intent of financial reform was to regulate the over the counter swaps markets, many of the rules, both in the United States and globally, have made significant changes to the futures markets, which were the model of regulation for the Dodd-Frank Act. At this point, reexamining the Commodity Exchange Act (CEA) and Dodd-Frank is of critical importance to make sure that the important risk management and price discovery functions provided by the futures markets are not constrained by regulation. My testimony today will focus on the self-regulatory functions ICE Futures U.S. undertakes and the overlap, particularly regarding position

limits, with the CFTC. In addition, I would like to discuss the recent conflicts in the global financial reform process.

ICE Futures U.S. Self-Regulatory Functions

As background, ICE Futures U.S. is a designated contract market owned by IntercontinentalExchange which is the leading global network of regulated exchanges and central counterparty clearinghouses for financial and commodity markets.

ICE Futures U.S. lists a broad array of contracts on the exchange including North American power and natural gas, and international agricultural commodities such as sugar, coffee, cocoa and cotton.

ICE Futures U.S. and its predecessor exchanges, which date back to 1870, have a strong history of overseeing position limits, accountability levels and exemption requests. We have market regulation teams in New York and Chicago. These teams employ market experts with decades of surveillance and compliance experience working in the derivatives markets that they oversee. This extensive, direct experience has guided our self-regulatory functions. In particular, the rules and procedures developed and used by our exchange to perform this important function were designed to incorporate the specific needs and differing practices of the commercial participants in each of our markets as those needs and practices have developed over time.

Self-Regulation Functions and *Bona Fide* Hedging

ICE Futures U.S.' flexibility and market expertise are very important in the context of *bona fide* hedge exemptions. In addition to the swap market reforms, Dodd-Frank made changes to long standing position limit and hedge exemption rules in futures. The CFTC, in interpreting these rules, is broadly transforming the role of the CFTC in the daily administration of position limits and the granting of hedge exemptions, from an oversight role to direct regulation of markets over which the futures exchanges currently exercise such authority. As outlined in recent CFTC meetings of the Agriculture Advisory Committee and the Energy and Environmental Markets Advisory Committee, these changes to the current exchange structure and the limiting of *bona fide* hedge exemptions will likely cause risk management issues for commercial users of the derivatives markets. As one example, the prohibitions or limitations on anticipatory hedging are likely to greatly constrain the risk management practices of energy and agricultural firms. It is worth pointing out that limiting hedging and risk management by commercial firms was obviously not the intent of the Dodd-Frank financial reforms.

In revisiting the CEA, we believe that the Committee should encourage the CFTC to reexamine the position limit proposal and in particular the effects on *bona fide* hedging and position limits in the non-spot month. For administering hedge exemptions, the CFTC's constrained resources and the significant time and resources that such an undertaking would require coupled with the time sensitive nature of exemption requests, we believe that the existing current structure reflects an efficient allocation of responsibility and resources that ensures commercial market participants will be able to continue to hedge their risks in a timely manner. In regard to position limits in non-spot months, the current position accountability regime has proven to be effective at balancing liquidity both in nearby month expiries and future month expiries. Our concern is that the implementation of limits that will apply in any month and all months may have the unintended consequence of concentrating volume and liquidity toward the prompt delivery months only. This would constrain an end-user's ability to effectively hedge a long dated exposure. We believe that the current regime is efficient from a resource standpoint and has proved to result in well-functioning markets that aid the price discovery and risk management needs of end-users. Therefore the current regulatory regime, which is overseen by the CFTC and incorporates rules subject to CFTC review, should remain in effect.

Conflicts in Global Financial Reform Efforts

Over the past 2 years, regulators in the United States and Europe have been working to address conflicts in the two major financial reform efforts: Dodd-Frank in the U.S. and EMIR in Europe. Currently, the negotiations are focused on harmonizing the clearing rules between the two jurisdictions. ICE Futures U.S. appreciates the hard work that the CFTC and its counterparts are putting into equivalence; however, we note that many of these issues arise from the implementation of very prescriptive financial reform rules. After addressing the conflicts on clearing regulation, U.S. and European regulators must address conflicts in a number of other areas as the EU finishes its financial reform legislation. Each of these conflicts, if left unresolved, could seriously hamper the operation of the derivatives markets, given their inherently international nature.

Before financial reform, these conflicts in regulation were the exception, not the norm, because financial regulation was based on a common set of regulatory principles. For example, since 1984, Section 4(b) of the Commodity Exchange Act expressly excluded foreign transactions from CFTC jurisdiction. The CFTC relied on foreign regulators to regulate foreign transactions and worked with regulators to adopt common principles that all regulated markets should adopt. Likewise, European regulators took a similar approach to U.S. markets. This approach was very successful, as it led to greater harmonization of regulation, yet allowed foreign regulators to oversee their institutions. We strongly encourage a return to this approach.

I would like to mention one more regulatory conflict: the one between global financial reform's commitment to derivatives clearing and the implementation of the Basel III capital requirements by international regulators. As noted by this Committee, the implementation of Basel III penalizes clearing by assessing a capital charge on initial margin collected by banks operating as clearing firms. Due to the way the capital charge is calculated, the impacts will be particularly acute on firms that hedge, given their directional exposure to the clearing firm. In addition, perversely, the capital rules discourage the collection of initial margin, which is the biggest risk mitigation of a derivatives transaction. Finally, the Basel Committee has delayed implementation of capital rules for uncleared transactions, which further disadvantages clearing.

Conclusion

In conclusion, I would like to note our appreciation of Chairman Massad's and the CFTC's efforts to address many of the issues I have noted today through reexamining some of the rules affecting the futures markets. We also appreciate the efforts of this Committee to reexamine the CEA and the impact of Dodd-Frank.

Mr. Chairman, thank you for the opportunity to share our views with you. I would be happy to answer any questions you may have.

The CHAIRMAN. Mr. Roth?

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Mr. ROTH. Thank you, Mr. Chairman, and thank you very much for the opportunity to appear here today. This Committee is taking up the issue of reauthorization at a particularly critical time. Implementing all the changes mandated by Dodd-Frank has been very challenging for regulators, like NFA, and I am sure even more so for the members that we regulate. What I would like to do this morning if—or this afternoon, if I could, would be to describe briefly some of the changes we have made at NFA to cope with those changes, and also talk about a couple of provisions in last year's bill that we strongly advocated last year, and we continue to support this year.

At NFA—the one thing that hasn't changed at NFA is our basic mission. To put it in a nutshell, our job is to help the CFTC. We are the industry-wide self-regulatory body. Regulation is all we do, and we are there to help the CFTC. We do that in a number of different ways. For example, in certain areas the CFTC actually delegates certain responsibilities to NFA, and in those areas of delegated responsibility, NFA acts as an agent on behalf of the CFTC. So, for example, the entire registration process, the CFTC has delegated that to NFA, and we act on behalf of the CFTC. Similarly, for commodity pool operators and commodity trading advisors, they are required to submit their disclosure documents to the CFTC. Well, NFA reviews those documents on behalf of the CFTC. Pool operators are—will submit 5,000 financial statements to us in the next few weeks for the pools that they operate, and those are re-

quired to be the submitted to the CFTC. NFA will review those on behalf of the CFTC.

In other areas, though, we don't act as an agent for the Commission, but rather as a self-regulatory body, like the CME, and ICE, and others. And in those areas, we basically perform examinations of our members and take enforcement actions when necessary, where we find members not in compliance with the rules. In that area the biggest change that has occurred in NFA involves swap dealers. Dodd-Frank required swap dealers to register with the CFTC. The CFTC, in turn, required them to become members of NFA. I should mention we have about a little over 100 swap dealers right now. And over the last 4 years we basically had to build from scratch a self-regulatory infrastructure for those swap dealers.

So we have added—our staff is almost 100 now, devoted solely to swaps compliance. We have a staff of almost 100. We are projecting additional hiring in our next fiscal year. Those people have been very busy. They have been busily engaged in reviewing hundreds of thousands of pages of policies and procedures that those firms were required to submit to the Commission, and we reviewed on the Commission's behalf. We have also prepared examination modules for each of the rulemaking areas where the Commission has completed its rulemaking, and we have begun performing onsite examinations of those members to monitor them for compliance.

All of this, as you might gather, has had a pretty significant impact on our resources. Our staff over the last 4 years has grown from about 300 to 480, and, again, we are projecting further growth next year. Our budget has more than doubled, from about $42 million 4 years ago to—it is going to be over $85 million in the next fiscal year. Those are pretty dramatic increases, but our board felt that each and every one of those increases in our budgets was mandatory, was essential for us to carry out our function.

With respect to last year's bill, if I could just mention briefly, there were a couple of provisions in last year's bill that were very important to us, from a customer protection point of view. One of them involved FCM insolvencies. The CFTC, a long time ago, had adopted a rule that provided that if an FCM was in bankruptcy, and if there was a shortfall in segregated funds, then customers received priority over all the other creditors of the FCM, and that was a good rule. That rule has served the industry well, it has served the customers well.

Unfortunately, a few years ago a lower court opinion cast some doubt on the validity of that rule. The court had questioned the CFTC's authority to adopt the rule that it had adopted. Last year's bill contained language to clarify that point, and to make clear that the Commission did have the authority to adopt that rule. We supported that rule—that provision then, we support it now. We hope it is in the bill that comes out of this Committee this year.

There were also some significant customer protection provisions in last year's bill codifying some of the work that NFA, and CME, and others had done with respect to the daily confirmation of customer segregated funds, increased transparency about FCM financial data, and other matters along those lines, and that was in-

cluded in the bill. We support codification of those provisions, and hope they are included again this year.

Mr. Chairman, I would be happy to answer any questions. Thank you very much, again, for the opportunity.

[The prepared statement of Mr. Roth follows:]

PREPARED STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Chairman Scott, Ranking Member Scott, Members of the Subcommittee, thank you for the opportunity to testify here today. I am President of National Futures Association. For those new to the Subcommittee, NFA is the industrywide self-regulatory organization for the derivatives industry. Our membership includes Swap Dealers, Futures Commission Merchants (FCM), Commodity Pool Operators (CPO), Commodity Trading Advisors (CTA), Introducing Brokers and all of the Associated Persons in the futures industry. NFA's responsibilities include registration of all industry professionals on behalf of the CFTC, passing rules to ensure fair dealing with customers, monitoring Members for compliance with those rules and taking enforcement actions against those Members that violate our rules.

In a nutshell, our job is to help the CFTC. For example, besides the registration process, NFA also reviews all CPO and CTA disclosure documents, CPO annual pool financial statements, and all of the policies and procedures that Swap Dealers are required to file with the CFTC. In addition, we immediately notify the CFTC if any of our exams uncover emergency situations and coordinate our responses with the Commission. We also meet regularly with the Division of Enforcement to avoid duplication of effort and also with the Division of Swaps and Intermediary Oversight on our exam process and rule development issues. More recently, at Chairman Massad's request, we have discussed other ways in which the Commission can take advantage of the regulatory resources of NFA and the CME. The Commission faces a huge job and we will continue to help in any way we can.

Reauthorization is always an important process for the industry as a whole and for NFA in particular. That's never been more true than it is today. NFA was pleased that key customer protections we supported were included in last year's bill, and I would like to address those provisions and reiterate why we support them. Let me begin, though, by discussing some of the challenges NFA has had to meet as a result of Dodd-Frank and other changes in the industry.

In some ways, NFA today is a very different organization than it was just a few short years ago. The most obvious change at NFA is size. Four years ago we had a staff of 300; today we have a staff of 480. Four years ago we operated on a budget of $42 million; this year our budget was over $80 million and we project another significant budget increase next year. We have always recognized that increased spending on regulation is not a virtue in and of itself. However, our Board was convinced that changes in the industry and in the scope of NFA's responsibilities made these increases essential. There are three main forces driving these changes at NFA, two of them related to Dodd-Frank.

Swap Dealer Membership

Dodd-Frank required certain Swap Dealers to register with the CFTC, and the CFTC required them to become Members of NFA. We have over 100 Swap Dealer Members, the vast majority of whom are either large U.S. banks or financial institutions, foreign banks or affiliates of one of those groups. Over the last several years we have built our Swaps Compliance Department from scratch. We began by building our senior management team and were lucky enough to recruit a team of six talented, experienced and dedicated individuals who have a total of over 100 years of experience in the swaps area. We have continued to build our staff and now have almost 100 individuals working exclusively on swaps compliance issues. We have reviewed hundreds of thousands of pages of policies and procedures that Swap Dealers were required to file with the CFTC, have begun the development of NFA's internal risk management guidelines to monitor Swap Dealer Members and developed examination modules for all of the rules adopted by the CFTC. This year we began conducting on-site examinations of Swap Dealer Members.

Much has been done in this area but much more work remains. We are working with the CFTC and other regulators to maximize our coordination and minimize duplication of effort. We are also working with the Commission to sort out the extent of NFA's responsibilities to monitor foreign firms that the CFTC has allowed to comply with comparable rules from their home jurisdiction. In this area, again, our primary goal is to limit wasting resources by duplicating the work of other regulators.

Swap Execution Facilities

Dodd-Frank also allowed for the creation of Swap Execution Facilities, electronic trading platforms for swaps. These SEFs have their own self-regulatory responsibilities to conduct surveillance of their markets. Of the 22 registered SEFs, 16 have contracted with NFA to perform certain surveillance functions on their behalf. As a result, NFA has tripled the size of our Market Regulation Department. We began our work in this area by developing a comprehensive set of the data elements NFA would need to receive from SEFs to perform our responsibilities. In doing so, we consulted extensively with both the industry and the CFTC. The result of those deliberations was a document listing the 150 data elements SEFs must provide to NFA. When SEF trading was launched on October 2, 2013, we were ready. The CFTC adopted our data elements as the industry standard, and with the CFTC we have begun discussions with international regulators to ensure uniform international standards.

Changes in Rules and Regulatory Practices

The third force driving change at NFA has nothing to do with Dodd-Frank. Following the failures of two FCMs, MF Global and Peregrine, a special committee of NFA's public directors commissioned an independent review of NFA's examination procedures. The study was conducted by a team from the Berkeley Research Group that included former SEC personnel who conducted that regulator's review of the SEC's practices after the Madoff fraud. The report stated that NFA's exams of Peregrine were conducted in a competent manner but also included a number of recommendations designed to improve the operations of NFA's regulatory examinations. The recommendations included areas such as hiring, training, supervision, risk management and continuing education. All of the committee's recommendations have been implemented and they have certainly made NFA a better regulator. Those changes come with a price tag, however, and we have increased the size of NFA's Futures Compliance Department by 33% since MF Global and Peregrine.

Improving examination procedures and increasing the size of the staff were helpful but they were not enough to accomplish the changes that we felt had to be made. Our Board also approved a wide range of new rules designed to prevent future FCM failures. Most importantly, rule changes adopted by NFA and CME now provide for the daily confirmation of balances for segregated customer funds held in over 2,000 accounts. We compare the confirmation from the depository with the daily information we receive from FCMs and immediately note and follow up on any material discrepancies. This rule change, and others I've described in previous testimony, mark a huge step in the protection of customer funds.

As I mentioned earlier, NFA was pleased that key customer protections we supported were included in the reauthorization bill approved by this Subcommittee last year. There were several provisions of that bill that were of particular importance to NFA, and I would like to briefly restate our support for those measures.

Strengthening Customer Protections in FCM Bankruptcy Proceedings

Over 30 years ago the CFTC adopted rules regarding FCM bankruptcies. Among other things, those rules provided that if there was a shortfall in customer segregated funds, the term "customer funds" would include all assets of the FCM until customers had been made whole. Several years ago, a district court decision cast doubt on the validity of the CFTC's rule. That decision was subsequently vacated but a cloud of doubt lingers on. This Committee attempted to remove that doubt in last year's bill by proposing to amend the Act to clarify the CFTC's authority to adopt the rule that it did. I believe there is a broad base of industry support for that approach, and we urge you to include that provision in any reauthorization bill that moves this year.

Codification of Customer Protection Rules

As I mentioned earlier, NFA, CME and other self-regulatory organizations adopted a number of very effective customer protection rules in the wake of MF Global and Peregrine. Two of the most significant rules involved the daily confirmation of customer segregated fund balances and additional requirements any time an FCM withdraws more than 25% of its own funds from segregated accounts. Last year's bill ensured that those protections could not be peeled back by requiring SROs to maintain those rules. We fully support that concept and, again, hope that this year's reauthorization bill contains similar provisions.

Changes to the ***De Minimis*** *Level for Swap Dealer Registration*

The current *de minimis* level of swap dealing that triggers swap dealer registration is $8 billion, but under the current structure that level will automatically be reduced to $3 billion without any affirmative rule making by the CFTC. The time

may well come when it is appropriate to adjust the threshold up or down, but the consequences of doing so could be very significant for both market participants and regulators, including NFA. A change of that magnitude should not happen by default. Last year's bill provided that the *de minimis* level could only be changed by the CFTC taking the affirmative step of amending its rules. We continue to support that provision and urge its inclusion in this year's bill.

Before I close let me also mention one issue that is of critical importance to all of us—Congress, regulators, market participants and the general public—cybersecurity. At NFA we need both an internal and an external focus on this important issue. Internally, we continue to do everything we can to protect the confidentiality of all of the data we hold, including all of the registration data we hold on behalf of the CFTC. Our security measures are constantly reviewed by our own staff, by the CFTC and by consultants we hire to try to penetrate our defenses. We believe that our security measures reflect the state of the art, but we take no particular comfort in that. We recognize that the risk of penetration will always be present no matter how extensive our defenses. Therefore, we are implementing countermeasures like enhanced monitoring and encryption across our systems to further protect our data in the event of a breach.

Our external focus is on providing our Members with the guidance they need to ensure that their security measures satisfy their regulatory responsibilities. Our Members range in size from huge multinational corporations with ultra sophisticated defenses to one person shops. We are working with the CFTC and the industry to develop guidance that would provide meaningful protections and be flexible enough to apply to all of our Members.

Mr. Chairman, I recognize both how difficult and how important the reauthorization process is for the derivatives industry and all of the end-users that depend on these markets for their hedging needs. I agree with Chairman Massad that we must always be sensitive to the costs imposed by regulation. This is particularly true as the number of FCMs continues to dwindle, concentrating more risk in fewer FCMs and limiting the FCMs that serve agricultural end-users. We look forward to working with the Subcommittee to strike the difficult balance that must be achieved and will be happy to answer any questions the Subcommittee may have.

The CHAIRMAN. Thank you. Mr. Corcoran?

STATEMENT OF GERALD F. CORCORAN, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, R.J. O'BRIEN & ASSOCIATES, LLC, CHICAGO, IL; ON BEHALF OF FUTURES INDUSTRY ASSOCIATION

Mr. CORCORAN. Chairman Scott, Ranking Member Scott, Members of the Subcommittee, thank you for the opportunity to appear before you today. I would first like to commend the Agriculture Committee for continuing the bipartisan approach to developing legislation. It is the spirit that resulted in the House passing a good CFTC reauthorization bill during the last Congress, and we look forward to a collaborative bipartisan process again in 2015.

The reauthorization legislation developed by the House Agriculture Committee during the last Congress contained several customer protection enhancements that FIA continues to support, including two key clarifications, one relative to the timing of an FCM's residual interest obligations, and another restoring legal certainty as to the utilization of property outside of the segregated customer accounts to ensure that customers are the highest priority in the event of an FCM bankruptcy.

In addition to the recent customer protection improvements, the entire clearing ecosystem has undergone major regulatory changes since enactment of the Dodd-Frank Act in the U.S. and the EMIR in Europe. When policymakers determine to extend clearing beyond futures and options to certain over-the-counter swaps, the role of the FCM also expanded. FCMs play a critical role in ensuring that cleared transactions are secured with appropriate margin to facili-

tate this clearing process. We operate in global markets, and if global regulations are not well coordinated, the markets will fragment within regulatory jurisdictions, and become far less liquid, to the detriment of the ultimate end-users.

I would like to highlight one global regulatory coordination challenge we are currently facing. Europe and the U.S. have developed differing requirements relative to margining methodologies that clearinghouses must apply. As clearing members of clearinghouses in each country, we are perplexed by recent suggestions that the competing methodologies should be run simultaneously, with clearing members and clients then subjected to the model resulting in the highest margin requirement on any given day. This overly complex and operationally risky policy seems to overlook the implications to those who post the margin, the client and the clearing member. Assuming that each regulatory jurisdiction is unlikely to prescribe identical requirements, the practicality of requiring dual registration or recognition hinges upon the various jurisdictions' ability to acknowledge regulatory differences and coordinate a reasonable path going forward.

I also want to briefly mention new reporting requirements that fall to clearing members. FCMs serve as the responsible party for the submission of various data sets to the CFTC, both for our own entities, as well as for our customers. Recent CFTC regulations require FCMs to collect certain customer data that has never been expected before. Not all customers are willing to provide this new information, which presents challenges to FCMs, who are then put in an untenable position of either ceasing to do business with the customer, or incurring regulatory risk. While we were happy to work with the Commission to improve the process surrounding new ownership and control reporting, some regulatory refinements are likely necessary in order for the data to be available and useful.

Additionally, the Dodd-Frank Act requires new Chief Compliance Officer annual reports that are quite extensive. These reports are linked to the filing of annual financial reports, even though the two reports are very different, and require different inputs from different parts of the organization. Given the complexity of compiling the Chief Compliance Officer's filings, it may be prudent to de-link the two filings.

Another critical area focus for the FIA is Basel III capital requirements for our prudentially regulated members. While my clearing firm is not affiliated with a bank, those FCMs who are face a real challenge relative to excessive capital costs for their client clearing businesses, making it increasingly expensive for many clearing member banks to offer clearing services to their clients.

At issue is the recently finalized leverage ratio, which treats client margin posted to a bank affiliated clearing member as a resource that can be used to leverage the bank, an assumption that seems to conflict with requirements in the Commodity Exchange Act and CFTC regulations that require client margin to be segregated for the protection of the customer, and thereby unable to be leveraged by the bank.

The lack of recognition of the CFTC requirements in the context of the banking regulator's new capital rules results in increased cost to the clearing system, including clients of bank affiliated

clearing members, capital costs that exceed tens of billions of dollars today, and hundreds of billions of dollars once more products are required to clear under the new swap clearing mandate.

These numbers are staggering, and, frankly, will result in fewer FCMs to support the overall clearing system, and fewer choices for customers who need to hedge their risk, all effects which, ironically, seem contrary to the principles of the G20 and the Dodd-Frank Act, which were intended to encourage more risk mitigation for the practice of clearing.

Over the 10 year period between 2004 and 2014, the pool of FCMs registered with the CFTC decreased by more than 50 percent, from 190 FCMs to 76 FCMs. The new capital requirements on bank affiliated FCMs will only serve to further consolidate the pool of clearing services available to customers, at the very time when more clearing is mandated.

In closing, I would like to remind the Subcommittee that the FCM function has proven to be an essential foundation for managing risk in the futures markets, and is integral for advancing the goals of the new trading and clearing requirements for swaps as well. We want to continue supporting the risk management needs of our customers in a productive way. This is a goal I know the Members of this Committee share, and I look forward to working with you as you consider the CFTC's role in achieving this mutual objective. Thank you.

[The prepared statement of Mr. Corcoran follows:]

PREPARED STATEMENT OF GERALD F. CORCORAN, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, R.J. O'BRIEN & ASSOCIATES, LLC, CHICAGO, IL; ON BEHALF OF FUTURES INDUSTRY ASSOCIATION

Chairman Scott, Ranking Member Scott, and Members of the Subcommittee, thank you for the opportunity to discuss matters affecting the cleared derivatives industry. I am testifying today in both my roles as Chairman and CEO of R.J. O'Brien and Chairman of the Futures Industry Association (FIA). As you consider reauthorizing the Commodity Futures Trading Commission (CFTC), FIA and its members stand ready to assist in any way we can. FIA is the leading trade organization for the futures, options and over-the-counter cleared derivatives markets. Our membership includes derivatives clearing firms, customers and exchanges from more than 20 countries. FIA's core constituency consists of futures commission merchants (FCMs), such as R.J. O'Brien that I manage in Chicago. As a trade association, our primary focus is the global use of exchanges, trading systems and clearinghouses for derivatives transactions.

I would first like to commend the Agriculture Committee for continuing the bipartisan approach to reauthorizing the CFTC. It is this spirit that resulted in the House passing a good bill during the last Congress. As derivatives markets are adapting and responding to major regulatory transformations, they need stability and certainty to thrive, and the House Agriculture Committee recognized this as they developed H.R. 4413 during the 113th Congress. This legislation contained provisions designed to make the CFTC operationally more effective, and FIA supports those enhancements to cost-benefit analysis and internal risk controls.

Customer Protection

One of the most important aspects of any legislation reauthorizing the CFTC is enhanced customer protection. As you know, the failures of MF Global Inc. and Peregrine Financial Group resulted in severe and unacceptable consequences for futures customers and the markets generally. The entire industry has been working collaboratively to identify and improve procedures required to better protect the in-

tegrity of these markets. A number of changes are already being implemented, many of which were recommended by FIA in the aftermath of these insolvencies:[1]

- The industry's principal self-regulatory organizations (SROs) have adopted rules that subject all FCMs to enhanced recordkeeping and reporting obligations. For example, chief financial officers or other appropriate senior officers are now required to authorize in writing and promptly notify the FCM's designated SRO whenever an FCM seeks to withdraw more than 25 percent of its excess funds from the customer segregated account in any day—these are funds deposited by the FCM into customer accounts to guard against customer defaults.
- The National Futures Association (NFA) is also collecting additional financial information from FCMs and posting the information onto its online Background Affiliation Status Information Center (Basic) system, a key step in giving customers the tools they need to monitor the assets they deposit with their FCMs. The new service provides the public with access to specific information about an FCM, such as the firm's adjusted net capital, the amount of funds held in segregated, secured, and cleared swaps accounts, and the types of investments that the FCM is making with those customer funds.
- A newly developed segregation confirmation system allows SROs to run comparisons of the balances in customer segregated, secured, and cleared swaps accounts at the depositories with the daily reports they receive from FCMs, and identify any discrepancies.
- A set of frequently asked questions on customer funds protection[2] has also been developed by FIA, which is being used by FCMs to provide their customers with increased disclosure on the scope of how the laws and regulations protect customers.
- In November 2013, the CFTC finalized new regulations for "Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations". FIA supports the vast majority of the comprehensive regulatory reforms contained therein and wishes to specifically applaud the Commission and the Agriculture Committee for devoting much time and attention to the appropriate timing of residual interest requirements.

The reauthorization legislation developed by the House Agriculture Committee during the last Congress contained several customer protection enhancements that FIA continues to support including two key clarifications—one relative to the timing of an FCM's residual interest obligations and another restoring legal certainty as to the utilization of property outside of the segregated customer accounts to ensure that customers are the highest priority in the event of an FCM bankruptcy.

Clearing Infrastructure Challenges

Clearing ensures that parties to a transaction are protected from a failure by the opposite counterparty to perform their obligations, and FIA's FCM members play a critical role in ensuring that transactions are secured with appropriate margin to facilitate this clearing process. Under the "Dodd-Frank Act" in the U.S. and the "European Market Infrastructure Regulation" (EMIR) in Europe, policymakers determined to extend clearing beyond futures and options to certain over-the-counter swaps, and as such the role of the FCM has also expanded. Because FCMs play a critical role in achieving and sustaining the clearing system, we would like to offer our thoughts on the ongoing development of various new regulatory initiatives.

Cross-Border Coordination

We operate in global markets and to assume otherwise is very dangerous given that market participants are best served with deep liquidity. If global regulations are not well coordinated the markets will fragment within regulatory jurisdictions and become far less liquid, to the detriment of the ultimate end-users. To date, much of the public regulatory scrutiny has focused on the cross-border regulation of trade execution parties, both the client and the swap dealers, but there are also cross-border challenges within the regulation of the infrastructure that is expected to support the clearing of derivatives. For example, the "Dodd-Frank Act" specifically provides the CFTC with the ability to exempt comparably regulated foreign

[1] See Futures Industry Association, Futures Markets Financial Integrity Task Force—Initial Recommendations for Customer Funds Protection: *https://americas.fia.org/articles/fia-task-force-issues-initial-recommendations-enhancing-customer-funds-protections*.

[2] See Protection of Customer Funds, Frequently Asked Questions: *https://americas.fia.org/articles/fia-issues-fourth-version-guide-customer-fund-protections*.

clearinghouses from registration with the U.S. regulator yet the CFTC has never established a means by which clearinghouses, also known as central counterparties (CCPs), might seek such exemptions. Thus any foreign CCP clearing swaps for U.S. entities must register with the CFTC, as well as their home country regulator. U.S. based CCPs who are registered with the CFTC and do business with European participants are required under EU law to be "recognized" by having equivalent regulations to those in Europe. Assuming that each regulatory jurisdiction is unlikely to prescribe identical requirements, the practicality of such dual registration or recognition hinges upon the various jurisdictions' ability to acknowledge regulatory differences and rely upon each other as front line regulators. I would like to highlight one specific example of a current regulatory coordination challenge we are facing: Europe and the U.S. have developed differing requirements relative to margin methodologies that CCPs must apply. As clearing members of CCPs in each country, we are perplexed by recent suggestions that the competing methodologies should be run simultaneously. As such, clearing members and their clients would be subjected to the model resulting in the highest margin requirement on any given day. This overly-complex and operationally risky policy seems to overlook the implication to those who post margin—the client and the clearing member. There has been very little transparency or involvement of the clearing members to date in the discussion between the CFTC and EU authorities.

Clearing Member Reporting Requirements

I also want to briefly mention new reporting requirements that fall to clearing members. FCMs serve as the responsible party for the submission of various data sets to the CFTC—both for our own entities, as well as our customers. Recently, the CFTC has modified the manner in which information on large positions is reported to the regulator by broadening both the scope of reportable positions and the amount of data required for the reports. The new Ownership and Control Reporting (OCR) rules require FCMs to collect certain customer data that has never been required before and not all customers are willing to provide this new information. This presents challenges to FCMs who are required by regulation to gather data from customers who are under no regulatory obligation to provide such information. The current OCR Rule puts FCMs in an untenable position of either ceasing to do business with customers or incurring regulatory risk. In addition, privacy laws in foreign countries raise legal ramifications for reporting entities and their customers located outside the U.S. While we are happy to work with the Commission to improve this process, some regulatory refinements are likely necessary in order for the customer data to be available to the FCM and useful to the regulator.

Additionally, the "Dodd-Frank Act" requires new chief compliance officer annual reports that are quite extensive. These reports are linked to the filing of annual financial reports even though the two reports are very different and require different inputs from different parts of the business. Given the complexity of compiling the chief compliance officer filings, it may be prudent to delink the two filings.

Basel III Capital Implications for Cleared Derivatives

Another critical area of focus for the FIA is Basel III capital requirements for our prudentially regulated bank members. While my clearing firm is not affiliated with a bank, those FCMs who are face a real challenge relative to excessive capital costs for their client clearing businesses. This result seems at odds with the principles of the G20 and the "Dodd-Frank Act," which were intended to encourage more clearing for its risk mitigating effects. Rather, these increased capital costs have made it increasingly expensive for many clearing member banks to offer clearing services to their clients. At issue is the recently finalized leverage ratio, which treats client margin posted to a bank-affiliated clearing member as a resource that can be used to leverage the bank. This assumption runs counter to the Commodity Exchange Act and CFTC regulations that require client margin to be segregated for the protection of the customer and thereby unable to be leveraged by the bank. The lack of recognition of the CFTC requirements in the context of the banking regulators' new capital rules results in increased costs to the clearing system (including clients of bank-affiliated clearing members) exceeding tens of BILLIONS of dollars today and hundreds of BILLIONS of dollars once more products are subjected to clearing under new swap clearing mandates.

Conclusion

These numbers are staggering and frankly will result in fewer FCMs to support the overall clearing system and fewer choices for customers who need to hedge their risk. Over the 10 year period between 2004 and 2014, the FCM community shrunk from 190 FCMs to 76 FCMs. The current number of FCMs registered with the CFTC has been reduced to less than half of those registered 10 years ago and is

down from nearly 100 at the end of 2013. These new capital requirements on bank-affiliated FCMs will only serve to further consolidate the pool of clearing service providers. The FCM function has proven to be an essential foundation for managing risk in the futures markets, and is integral for advancing the goals of the new trading and clearing requirements for swaps as well. As the Committee considers how best to ensure these markets are properly regulated, we encourage a holistic view of the clearing infrastructure and its sustainability.

I am fortunate to represent a wide array of stakeholders in the derivatives industry—all of whom want to see this industry continue to support the risk management needs of its customers in a productive way. This is a goal I know the Members of this Committee share and I look forward to working with you as you consider the CFTC's role in achieving this mutual objective.

The CHAIRMAN. Mr. Bernardo?

STATEMENT OF SHAWN BERNARDO, CHIEF EXECUTIVE OFFICER, TPSEF, INC. AT TULLETT PREBON, JERSEY CITY, NJ; ON BEHALF OF WHOLESALE MARKET BROKERS ASSOCIATION, AMERICAS

Mr. BERNARDO. Thank you, Chairman Scott, Ranking Member Scott, and Members of the Subcommittee. My name is Shawn Bernardo. I am the Chief Executive Officer of tpSEF, Tullett Prebon's Temporarily Registered Swap Execution Facility, or SEF. Tullett Prebon is a founding member of the Wholesale Market Brokers' Association, Americas, an independent industry body whose membership includes the largest North American inter-dealer brokers. I appear before you today in my capacity as a WMBAA Officer and Board Member. I am pleased to share with you the SEF perspective on CEA reauthorization and Dodd-Frank implementation.

By way of background, I have spent nearly 20 years in the inter-dealer broker industry. My career began in 1996 as a U.S. Treasury broker. I have spent the vast majority of my career building various electronic and hybrid platforms in fixed income markets. As SEFs, WMBAA member firms are the trading platforms that help foster liquidity. We do not hold securities or customer funds. SEFs are regulated intermediaries that work to match buyers and sellers of swaps.

Congress fashioned the newly regulated swap market to force the competition between trading platforms in order to ensure that end-users seeking to manage risk can do so effectively. There are 22 temporarily registered SEFs, with three additional applications pending before the CFTC. Furthermore, SEFs compete against one another for their customers' trades on price, service, and liquidity. I would like to share two main points with you today.

First, since the CFTC adopted final SEF rules in June 2013, the WMBAA member firms have been working diligently to implement the new requirements and meet the standards necessary to obtain permanent registration. This, however, has not been an easy task. Second, the WMBAA is encouraged by recent speeches by the CFTC Chairman and Commissioners, including Commissioner Giancarlo's white paper on swap trading rules, suggesting that the agency may consider adjusting various aspects of its SEF rules and swap trading regulations.

Let me briefly describe WMBAA member firm experiences as they relate to SEF registration. SEF applications have been pending before the CFTC since the summer of 2013. WMBAA member

firms have each filed registration forms, participated in many staff visits and calls, and responded to document requests, exhaustive questionnaires, and rulebook inquiries. And let me also say that the CFTC staffers are hardworking, dedicated, and have been fully engaged in this process.

The WMBAA remains hopeful that the SEF registration will be issued later this year so that we can dedicate more of our resources to providing competitive, vibrant, and transparent markets. But SEF compliance remains challenging because the regulatory landscape continues to shift as the CFTC issues numerous no action letters, guidance, and interpretations of the rules. I would like to share one example from my written testimony that illustrates our concern with not only the nature of the CFTC's rulemaking process to date, but also the impractical burdens imposed by certain CFTC regulations.

To the surprise of the market participants, a footnote to the final SEF rules, Footnote 195, imposed an obligation on SEFs to collect the underlying master agreements between counterparties. In response to market participants' concerns to this footnote, CFTC staff ultimately issued no action relief, which in turn imposed another unforeseen obligation on SEFs, which has proven to be unworkable.

In sum, the no action relief failed to provide meaningful relief to the industry. We continue to engage the CFTC staff on this point, and hope the agency will resolve the issue shortly, but this approach to regulation fails to provide the legal certainty and stability needed for SEFs and swap trading to flourish.

Second, as it relates to altering, or fine tuning the SEF and swap trading rules, in addition to the problems from Footnote 195 I just referenced, there remain other pressing implementation areas that continue to frustrate the SEF's registration and swap trading process. My prepared statement includes a list of pending implementation issues that continue to delay the registration process.

When SEF rules were adopted 2 years ago, Commissioners demonstrated a commitment to reassessing the policy judgments as the markets evolve, and the CFTC gains more experience and new information. We urge the agency to, as both Chairman Massad and Commissioner Bowen have said, enhance the rules to fit the current market structure.

Finally, as the Congress considers CEA reauthorization, the WMBAA urges the Committee to ensure that the agency remain true to the CFTC's principle based approach to regulation. Overly prescriptive rules will artificially restrict the flexibility that benefits all market participants, including the end-users, and inhibit U.S. financial markets from remaining the most competitive and liquid in the world.

Thank you for the opportunity to comment on these very important issues. I would be happy to answer any questions.

[The prepared statement of Mr. Bernardo follows:]

PREPARED STATEMENT OF SHAWN BERNARDO, CHIEF EXECUTIVE OFFICER, TPSEF, INC. AT TULLETT PREBON, JERSEY CITY, NJ; ON BEHALF OF WHOLESALE MARKET BROKERS ASSOCIATION, AMERICAS

Introduction

Thank you, Chairman Scott, Ranking Member Scott, and Members of the Subcommittee for providing this opportunity to participate in today's hearing.

My name is Shawn Bernardo. I am the Chief Executive Officer of tpSEF, Inc., Tullett Prebon's temporarily-registered swap execution facility (SEF). Tullett Prebon is a founding member of the Wholesale Markets Brokers Association, Americas (WMBAA), an independent industry body whose membership includes the largest North American inter-dealer brokers.[1]

I appear before you today in my capacity as a WMBAA Officer and Board Member.

Tullett Prebon is a leading global inter-dealer broker of over-the-counter (OTC) financial products.[2] My company has a global presence and the business covers money market and foreign exchange products, fixed income, interest rate derivatives, equities, and energy products, and offers voice, hybrid, and electronic broking solutions for these products. Tullett also offers a variety of market information services through its inter-dealer broker market data division, Tullett Prebon Information.

My career began in the inter-dealer broker industry in 1996 as a U.S. Treasuries broker. As you may know, the secondary market in U.S. Treasuries trades exclusively over-the-counter, both electronically and via voice, and stands as an example of one of the most liquid and efficient markets in the world. My experience as a broker allowed me to help create electronic brokering systems for U.S. Treasuries, U.S. repurchase agreements, credit default swap index products, and interest rate swaps. I have spent the vast majority of the past 15 years building various electronic and hybrid brokering platforms to promote more efficient markets in Fixed Income, Energy, Credit, FX Options, and Interest Rates.

WMBAA Supports Recent CFTC Statements to Revisit Issues Related to SEF and Swap Trading Rules

The WMBAA is encouraged by recent statements by the Commissioners of the Commodity Futures Trading Commission (CFTC or Commission) suggesting that the Commission may consider potential revisions to various aspects of its swap regulations promulgated pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), including reforms specifically related to SEFs and swap trading. We support these efforts and continue to support steps to preserve and promote the clear Congressional intent for SEFs to operate "through any means of interstate commerce."[3]

As the Congress considers Commodity Exchange Act reauthorization, the WMBAA urges legislators to ensure that the implementing agencies honor the statute's expectation that swap trading rules will, consistent with the CFTC's "principles-based" approach to regulation, allow for the flexibility that benefits all types of market participants and ensure that U.S. financial markets remain the most competitive and liquid in the world. In reviewing the evolution of the SEF definition throughout the legislative debate, one can see that each of the words was measured and selected with extreme precision.[4]

Recently, before the full House Committee on Agriculture, Chairman Tim Massad expressed an openness "to looking at how [the CFTC] can fine-tune and improve

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[1] The WMBAA is an independent industry body representing the largest inter-dealer brokers. The five founding members of the group—BGC Partners, GFI Group, ICAP, Tradition, and Tullett Prebon—operate globally, including in the North American wholesale markets, in a broad range of financial products, and have received temporary registration as swap execution facilities. The WMBAA membership collectively employs approximately 4,000 people in the United States; not only in New York City, but in Stamford, Connecticut; Chicago, Illinois; Louisville, Kentucky; Jersey City, New Jersey; Raleigh, North Carolina; and Houston and Sugar Land, Texas. For more information, please see *www.wmbaa.org*.

[2] For more information, please see *www.tullettprebon.com*.

[3] The term "swap execution facility" means a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that (A) facilitates the execution of swaps between persons; and (B) is not a designated contract market.

[4] *See* Letter from Stephen Merkel, Chairman, and Shawn Bernardo, Vice Chairman, WMBAA, to the Honorable Michael Dunn, Commissioner, CFTC, dated June 21, 2011, available at *http://www.wmbaa.com/wpcontent/uploads/2012/01/14_Letter_MDunn_SEF_06-21-11.pdf*.

rules to enhance trading." [5] Calls for the Commission to consider potential revisions to its Dodd-Frank Act regulations have also been raised by Commissioner Mark Wetjen,[6] Commissioner Sharon Bowen,[7] and Commissioner J. Christopher Giancarlo with the recent release of his white paper on these topics.[8]

The WMBAA appreciates the Commission's careful and deliberative approach to the regulation of SEFs. The implementation of the SEF regime has not been without its challenges and, given the unique characteristics of the OTC swap market, certain requirements have proven to be impracticable to implement or detrimental to market liquidity. Accordingly, the WMBAA supports the Commissioners' recognition that the regulations should be reassessed on an ongoing basis and appropriately modified based on its experience.[9]

Since the Commission's adoption of final SEF regulations in June 2013, the WMBAA member firms have been working diligently to implement various requirements and have actively engaged Commission staff throughout the implementation process. The WMBAA continues to be committed to working with the Commission and its staff to ensure that the regulations are implemented in accordance with the underlying statutory intent of the Dodd-Frank Act and seeks to accomplish the legislation's goal to "promote the trading of swaps on swap execution facilities."

Committed Focus on Permanent SEF Registration

While each of the WMBAA member firms' SEFs has received temporary registration, our members recognize the importance of permanent SEF registration to providing the market with the certainty and stability needed for swap trading to flourish.[10] Accordingly, the WMBAA is hopeful that continued active engagement with the Commission and its staff on these implementation issues will serve to expedite the permanent registration process.

SEF applications have been pending with the CFTC since the summer of 2013. Our association's members have each filed a Form SEF and associated registration materials with the Commission; participated in a series of staff visits and conference calls; and responded to document requests, exhaustive questionnaires, and rulebook provision inquiries. We continue to treat these requests with the seriousness and attention they deserve as each company strives to attain permanent registration. We have been working very closely with the staff to address these issues, and the WMBAA remains hopeful that SEF registrations will be issued later this year so that we can dedicate more of our resources to providing competitive, vibrant, and transparent trading platforms.

Concern about CFTC Policymaking through Staff Guidance and No-Action Relief

WMBAA SEFs have dedicated significant resources over the last few years to ensure that OTC swap trading remains competitive and transparent. Our association

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[5] *2015 Agenda for CFTC: Hearing Before the House Committee on Agriculture, 114th Cong.* (Feb. 12, 2015).

[6] *See* Remarks of Commissioner Wetjen, Nov. 14, 2014 (suggesting certain actions that the CFTC should consider related to trade execution in order to minimize fragmentation), available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/opawetjen-10*.

[7] *See* Statement of Commissioner Bowen, Dec. 1, 2014 (stating that "the best way of viewing changes to [the CFTC's Dodd-Frank Act rulemakings] is not that [the CFTC is] tweaking them, but rather that [the CFTC is] enhancing them. Sometimes that may mean making the rules more cost-effective and leaner, but at other times that will mean making them stronger than before. Enhancing a rule can mean reducing burdens to business while strengthening protections for the public"), available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement120114*.

[8] *See* Commissioner Giancarlo White Paper, "Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank" (Jan. 29, 2015), available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf*.

[9] *See* remarks by CFTC Commissioner Mark Wetjen, Open Meeting on the 29th Series of Rulemakings Under the Dodd-Frank Act, May 16, 2013, available at *http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission_051613-trans.pdf* ("The Commission, therefore, must remain open to reassessing the policy judgments in these final rules as the markets evolve, as the Commission has provided new information, and as the Commission benefits from its experience overseeing the new SEF market structure. In short, the Commission must remain open to course correction where necessary and ensure that the swap regulatory regime keeps pace with the markets that it governs.").

[10] In 2014, SEF average daily notional volumes accounted for 52.4% of reported rates volume and 62.3% of reported credit volume. In addition, cleared interest rate and cleared CDS index transactions grew as a percentage of total volume in 2014, accounting for 76.5% of notional volume in rates and 74.7% of notional volume in CDS index trades. See ISDA SwapsInfo 2014 Year in Review (Mar. 2015), available at *http://www2.isda.org/functionalareas/research/research-notes/*.

was encouraged that the final rules were adopted in a "technology neutral" manner that would foster future innovation in the industry.[11]

However, notwithstanding the promulgation of final Part 37 rules, the SEF regulatory landscape continues to shift as CFTC staff continues to issue numerous no-action letters and interpretive guidance and develops new interpretations to the preamble (and footnotes to preamble discussion) of the Part 37 rules. To be clear, we appreciate the hard work and dedication of the CFTC staff engaged on these issues. Our concern is that the Commission's actions, in their entirety, have been difficult to comply with and lack the permanence needed to build systems and platforms to their requirements.

I'd like to share one example that demonstrates some of the concerns we have about how certain requirements have been implemented. CFTC regulation 37.6 requires a SEF to "provide each counterparty to a transaction that is entered into on or pursuant to the rules of the [SEF] with a written record of all of the terms of the transaction which shall legally supersede any previous agreement and serve as a confirmation of the transaction. The confirmation of all terms of the transaction shall take place at the same time as execution."

In the preamble, the Commission explains how it has considered and responded to the many comments submitted in response to its proposed rule before adopting the final regulation. However, in a corresponding footnote in the preamble—footnote 195—the Commission states that "[t]here is no reason why a SEF's written confirmation terms cannot incorporate by reference the privately negotiated terms of a freestanding master agreement for these types of transactions, provided that the master agreement is submitted to the SEF ahead of execution and the counterparties ensure that nothing in the confirmation terms contradict the standardized terms intended to be incorporated from the master agreement."

When SEFs discovered this footnote buried in the preamble discussion of the final rule, they joined other market participants in immediately engaging the CFTC and its staff to determine how a SEF could demonstrate compliance with this statement. Following a series of conversations and three separate formal industry petitions for relief, the Division of Market Oversight ultimately issued no-action relief allowing a SEF to incorporate the underlying terms by reference and waiving the requirement that a SEF must receive or maintain each underlying agreement on record. At the same time, however, the no-action relief imposed a new obligation on SEFs to "glean all confirmation data" from executed swaps "[w]here a SEF has incorporated the swap's governing documents by reference."[12] The Division of Market Oversight and the Commission did not provide any guidance on how a SEF could comply with its new duty to "glean" this information and, as a result, fell short in providing meaningful relief.

There remain several other pressing implementation issues that continue to frustrate the SEF registration and swap trading process. For example, other issues relate to the time between a SEF disseminating trade data to its participants and reporting the trade to a swap data repository, referred to as the "Embargo Rule"; specific audit trail requirements for voice-based platforms; the calculation of financial resources that a SEF must maintain; the "made available to trade" or "MAT" process; SEF monitoring for position limits violations; the disparate regulatory treatment of economically equivalent swaps and futures products; how to resolve swaps executed with operational or clerical errors; and a series of questions related to the cross-border application of SEF and swap trading rules.

Conclusion

The WMBAA thanks the Subcommittee for the opportunity to comment on these very important issues. I would be happy to answer any questions you may have.

The CHAIRMAN. Gentlemen, thank you for your testimony, and I yield myself 5 minutes for the first questions, and then we will

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[11] *See* remarks by CFTC Chairman Gary Gensler, Open Meeting on the 29th Series of Rulemakings under the Dodd-Frank Act, May 16, 2013, available at *http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission_051613-trans.pdf* ("In addition, as Congress said in the definition of a swap execution facility that it could be by any means of interstate commerce. This rule is technology neutral. Telephones work. Maybe it's because I'm 55 years old, but Congress made the decision, and we're just implementing that decision that this rule is technology neutral. As long as there is an order book and somebody can do the minimum functionality around requests for quotes, have an audit trail and the other provisions of the rule, it's technology neutral.").

[12] *See* CFTC Letter No. 14–108 (Aug. 14, 2014), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-108.pdf*.

move through to Mr. Scott, and then rotate through the Committee.

Mr. Jackson, this Committee has been examining growing difficulties with the cross-border application of new derivatives regulations for several years now. Do you see any cause for optimism that the CFTC and foreign regulators may come to any agreement?

Mr. JACKSON. Thank you for your question, and the short answer is yes, I do. The long answer is the reason I believe that is that the regulators, both in Europe, as well as Chairman Massad and his team, are focused on the right thing, which is true equivalence. Because without true equivalence, you have an outcome where you can, unfortunately, create global disruption in the way that people are trading on these markets, both in Europe and the U.S., because they are truly global markets. And second, an outcome could be what Mr. Corcoran referenced, in terms of the operational inefficiencies, and headaches that it can create if you don't have true equivalence.

One other comment I would make there is that when we are talking about true equivalence, where we are today, it is not the same. The margin methodologies that are used in the clearinghouses are different, and can create different outcomes. In the U.S., the model that is used is 1 day gross. In Europe, it is 2 day net. And there are scenarios where those do give you the same answer, or very close to the same answer.

If you are a very large FCM, and you have a portfolio of trades that have a lot of offsets, that can be net against each other, yes, you get much closer to that 1 day gross answer. If you have a portfolio of customers that are market-makers, that tend to have positions that offset in their portfolios, your answer will be very close in 1 day gross, 2 day net. Where they are very different is if you are a much smaller FCM, if you are a much smaller clearing member that may have directional portfolio that doesn't net. There you are not going to get the benefit of netting, and they will be very different. Or if you are an FCM or clearing member that provides specialized services for hedgers, commercial hedgers, because those commercial hedgers, at the end of the day, are directional in nature, when you look at their futures positions, because they are offsetting it against physical risks that they have.

So for entities that have that type of exposure, they are not going to be able to net, and the impact of where Europe *versus* where the U.S. is going to be is going to be quite significant.

The CHAIRMAN. Thank you. Mr. Duffy, I would ask you that same question.

Mr. DUFFY. Okay. I will try not to say the same thing as Mr. Jackson said, but he is correct, except for 1 day gross is without collection of higher margin than 2 day net. And for some of the examples he gave you in the portfolios, but when you run most of these portfolios, which we have done for the European Union, we have showed them that we collect more money here in the United States under our margining regime. And for us not to be deemed equivalent, some of this cross-border nonsense, for lack of a better term, that has been going on for the last 2 years is becoming ridiculous.

I think we are getting into a competitive trade issue, Mr. Scott. I think that entities in the European Union are looking for a leg up on U.S. institutions. I think that is inappropriate. There is no question that we will get this resolved. The question is when. But we should not let it go to a point where we keep pushing dates certain out in order to give one particular entity a leg up on another entity in a different jurisdiction. That is my concern, Mr. Scott, and I am concerned that is where we are headed right now. So I am not as optimistic as Mr. Jackson that we will get there as soon as we should.

The CHAIRMAN. So with regard to preventing the regulators from finding common ground, it is a matter of, in your opinion, regulators trying to give an advantage to European——

Mr. DUFFY. European regulators said to us, sir, we went to them, and what Mr. Corcoran said earlier, we want to have this higher of issue, but we even went to them and said, "We will accept the higher of, whatever you want, just tell us what you want."

The CHAIRMAN. Yes.

Mr. DUFFY. We will accept that margining regime, the higher of 1 day gross *versus* 2 day net. They came back to us and said, "That is fine, as long as it only applies to the United States." So when you get a response like that, there is nothing more than a competitive issue that nobody has an interest in settling until you can get the entities in your jurisdiction a leg up on the U.S.

The CHAIRMAN. Mr. Jackson, what do you think is preventing the international regulators from finding that common ground?

Mr. JACKSON. I think they realize that at the end of the day, we need to have true equivalence, what the exact models are that we use in the U.S., and when we determine what is the margin that is established for a particular futures position should be the same as what it is in Europe. And they are focused on getting to that end goal. And I know that Chairman Massad, from the conversations I have had with him, and that our team and our staff has had with the European regulators, that is the end goal that people are trying to get to. When it comes to the——

The CHAIRMAN. My time has expired, so let me have the courtesy for the other Members. Let me turn it over to my colleague, Mr. Scott.

Mr. DAVID SCOTT of Georgia. Thank you very much, Chairman Scott. Our Committee here is very concerned about the importance of, and the impact of, the Basel III capital rule on clearing, especially the supplemental leverage ratio. I would like to ask the panel to weigh-in on this. Do you think that the supplemental leverage ratio will impact the futures business?

Mr. CORCORAN. I will be glad to answer that question, and provide you the FIA feedback. The FIA that represents the futures commission merchants in this country has done extensive data collection from our members, and the answer to your question is yes, the supplemental leverage ratio is going to impact the ability to serve customers, and the cost to customers in the United States, and we see that today already, that there is increasing price changes going to the end line client based on the leverage test.

The leverage ratio, and I believe the Agriculture Committee has already sent a letter to the Treasury on it, is punitive to the bank

owned FCMs in the sense that it doesn't recognize that the margin funds on hand at FCMs are in no way able to be leveraged by the banks. And although the Basel Committee has taken many, many meetings with our constituents from the banking industry, we have, to date, have had no relief on this matter. But it certainly is, and will, have an impact on the ability for bank FCMs to provide customer service and customer products to their bank customers.

Mr. DAVID SCOTT of Georgia. So could you tell us again what would be the greatest impact—where is that—will it be felt in the market? Real quick.

Mr. CORCORAN. I think likely that there will be bank affiliated FCMs exiting the marketplace, and therefore we will have fewer FCMs. It is just very, very difficult to get the return on capital that a bank is interested in receiving when you double the size of the capital contributed to the FCM for this product.

Mr. DAVID SCOTT of Georgia. Thank you very much. Mr. Duffy, let me turn to you. I read your testimony, which was very good. You mentioned an important point that I am working on, and that is to make sure that the CFTC is funded. And in your statement, you mentioned the importance of the CFTC having proper funding. Could you expand on that just a little bit and tell us why a fully funded Commission is very important, in terms of regulating this market?

Mr. DUFFY. First of all, we talked earlier, and in both of your opening statements you talked about the growth of the derivatives industry, especially here in the United States, but globally. In order for the United States to remain in this competitive world that we live in, and to prosper in this world, for people that do the risk management, we always need to have a regulator that has the utmost credibility to the marketplace. I am a big, big believer in that, sir. And then to have them properly, funded from a revenue standpoint, and also to have a full complement of Commissioners is also just as important to the credibility of that agency.

The question has always been, Mr. Scott, as you know, how do we get there? How do you fund these agencies? Who is going to pay for these agencies? When you are looking at a multitrillion dollar a year budget that the government has today, I will tell you that, for several hundred million dollars, this serves a great public service, to fund this agency at an adequate level, because if these spreads were ever to widen, the cost that that would bear on the consumers, because the spreads widen, and then the prices get skewed, it could cost billions of dollars——

Mr. DAVID SCOTT of Georgia. Correct.

Mr. DUFFY.—to consumers. So it is important to fully fund them. It is important, from a credibility standpoint, on the global scale that we operate under today.

Mr. DAVID SCOTT of Georgia. And would you care to—I know you follow this very closely. Would you say at this point that the CFTC is adequately funded, or would need more funding?

Mr. DUFFY. It is not for me to determine what is adequately funded. I will tell you that they have done a remarkable job through its history in regulating. Business has been growing at 20

to 25 percent on an annual basis over the last 30 years, so I will say they have done a great job.

Mr. DAVID SCOTT of Georgia. All right. Let me go to you, Mr. Roth. You mentioned in your statement that—I guess it would be sort of outsourcing—that you do some outsourcing work for the CFTC. I want to put that in this context of funding, and making sure the CFTC is operating. Given the fact that you do both regulating your own, and enforcing your own members for your group, you also work—and do work for the CFTC. How would you juxtapose this in light of the funding appropriateness for CFTC?

Mr. ROTH. Well, it is interesting, Congressman, if you take a historical perspective, back when NFA was first formed, the very purpose of forming it was to relieve the Commission of some of the stresses that it was feeling back 30 years ago, and that was part of our original design, and our original purpose, and it has remained one throughout our existence, so we work very closely with the Commission. All the divisions of the Commission, not just on those where we have formal delegations.

We are in daily contact with the Commission, including the Chairman's office. We have had recent discussions with the Chairman's office, initiated by Mr. Massad, looking for other ways in which the Commission can make better use of the resources of NFA, and the CME, and other SROs.

Mr. DAVID SCOTT of Georgia. My time is getting short. I wonder if you might care to just say, given your intimate working with them as staffing, you would have some insight knowledge in terms of your own thought as to their funding level being sufficient or not?

Mr. ROTH. And, Mr. Chairman, again, they are our oversight agency, we are not theirs, but I can tell you these are very challenging times for regulators. Like, you can just look what has happened to our budget, where our budget has doubled over the last 4 years. So I understand the stresses that they are going through.

Mr. DAVID SCOTT of Georgia. Thank you.

The CHAIRMAN. Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman, and I appreciate you and the Ranking Member for holding this meeting. I agree with both of you, we accomplished a great deal in the efforts to try and reauthorize CFTC in the last session of Congress, and that was a period of time it was a little bit difficult to get anything done, the farm bill being a classic example. In this case we did our work, but the other body couldn't quite get there, so that means, to our panelist friends, we have to start all over again. A certain amount of these questions and observations you have discussed time and again through the whole process, but one more time.

And I know, Mr. Duffy, that you are a mild mannered timid fellow, but I believe in the reauthorization process, when the phrase *user fee* or *transaction tax* came up, I watched your eyes dilate. Could you, for the record, as we begin this process again, if you have any kind of a timid opinion of that, offer it to us.

Mr. DUFFY. Well, again, sir, user fee transaction taxes are the most penny wise, dollar foolish thing you could ever have in an industry such as ours. We are not talking about millions of market-maker participants, like they have in securities, where you could

charge a fraction on a trade that is going to go on for days, weeks, months, or years, and so it really hasn't hit. We have people creating liquidity so folks could do risk transfer. And we are talking about a very small universe of those people creating that liquidity.

If you take their cost of business and add 30 to 40 percent in order to fund an agency, I assure you they will take those spreads and widen them. That would damage the markets immensely for the good folks of Oklahoma, for other people around this world that are trying to put food on the tables of American people, and shipping it overseas at a cost-effective rate.

I will give you an example today, the corn yield in Iowa and the corn yield in Illinois last year alone were record levels. We could take corn to $3.30 a bushel, add $1½ on it, and send it to China for ½ the price they are growing it today. We didn't do that, but if we don't have efficient marketplaces, this markets will get skewed, and we will have the same prices in other countries around the world.

So it is incredibly foolish to go down a path of trying to introduce a tax on—a small tax on a very small population of people which will damage the spreads immensely. Thank you for the question.

Mr. LUCAS. Thank you for clarifying that process. And I will go back to you again, Mr. Duffy, and anyone else who wants to comment on this, but let us talk for a moment about the equivalency issue. And you mentioned June 16 as being a critical moment. If this issue is not addressed, capital is a very fluid thing in the world we live in. How fast does the situation begin to deteriorate?

Mr. DUFFY. We are already seeing clients today, sir, look for alternatives outside of the United States. That is not a good thing when you are in a global market, especially when they are looking at alternatives that are in Singapore, or other parts of the world that are no different than what the United States is offering today.

To me, this is a very large slap in the face to the United States of America by the European Union by not granting this equivalence when they are prepared to grant the equivalence to much smaller nations, with the same type of regimes that we have here in the United States. This is a big deal for us. We need to get it done. The uncertainty of it, sir, is more important.

You are going to hear how we are going to push a date out, not to worry about, we will get it done, we are making progress. That doesn't do an end-user any good when he needs a date-certain, because he knows there is another date yet to come. It is no different than Dodd-Frank, sir. We addressed this when you were Chairman of the Committee. We have to have certainty. Whatever the rules are going to be, let us have certainty. And to have this uncertainty around what the regulations are going to be, and who can play at what cost, is not good.

Mr. LUCAS. Therefore, if we don't manage it well, we could damage what has traditionally been a very strong industry in this country for a generation.

Mr. DUFFY. It doesn't take much to take a kink out of the armor in any particular market, especially something like our market. It is based upon an ecosystem that includes all, and when you start to take pieces out of it, it becomes less efficient. When it becomes less efficient, the costs go up. So it doesn't take much, sir.

Mr. LUCAS. Sounds like, Mr. Chairman, on a lot of things, time is of the essence, and I am proud we have a good pair of leaders on the Subcommittee. I yield back the balance of my time.

The CHAIRMAN. Thank you, Mr. Chairman. Mrs. Kirkpatrick.

Mrs. KIRKPATRICK. Thank you, Mr. Chairman, Ranking Member Scott. Gentlemen, thank you for your testimony here today. I am a former prosecutor, and so my questions are going to be about enforcement. How much of the Commission's enforcement actions do you think are seen just as the cost of doing business? Do you know what I mean? Is it still that bad actors can just factor it into the cost of doing business.

Mr. ROTH. Yes, maybe I could talk about that a little bit. Obviously, I can't speak for the Commission, but I can tell you that it is way more than the cost of doing business, because the CFTC and NFA together meet on a quarterly basis with representatives of the U.S. Attorney's office and the FBI and Postal inspectors to tell them all about the fraud cases that we have worked up, and to try to get—the most effective thing you can do for a fraud is put people in jail.

Prosecutorial resources, as you know, are so scarce, but we have worked very hard to build those relationships, and we have had a significant increase in the number of criminal prosecutions that are resulting from violations of the Commodity Exchange Act. So for those people that are committing fraud, they are risking more than the cost of doing business. They are risking their liberty.

Mrs. KIRKPATRICK. How effective do you think the enforcement actions have been since 2009, then?

Mr. ROTH. Well, that is always hard to measure, isn't it? From my own perspective, sometimes I would prefer to see enforcement cases go down if it meant that compliance was going up, rather than cases that are just being missed. But overall, certainly the Commission's cases on LIBOR have had tremendous impact around the world, as motivating further reform. The Commission's done a fine job in that area, and overall the enforcement cases are having an impact.

Mrs. KIRKPATRICK. Any other members on the panel wish to comment on that?

Mr. CORCORAN. I would, if you will.

Mrs. KIRKPATRICK. Mr. Corcoran, yes.

Mr. CORCORAN. On behalf of the FIA, and also our organization, R.J. O'Brien and Associates, in no way do we think enforcement is the cost of doing business. We respect the rules, and we invest greatly in the law and compliance factors in our organizations, and I know our member firms at FIA do as well. Our brand name, and our brand value, is important to us, it is important to our clients, and running a business according to the rules is paramount to how we operate.

So I don't see this as an issue in the industry as enforcement is a cost of doing business. It is taken very, very seriously. No one wants to see their name in a press release from the CFTC enforcement action. The enforcement actions that have taken place since 2009 have reinforced the need for all FCMs to take a strong look at how they operate their business and take responsibility for it.

Mrs. KIRKPATRICK. Do any of you see ways that the enforcement actions can be improved? Any comments on that?

Mr. ROTH. I don't mean to——

Mrs. KIRKPATRICK. It is open to the whole panel. I just——

Mr. ROTH. Yes.

Mrs. KIRKPATRICK.—if anybody has any thoughts, I would like to hear from all of you.

Mr. ROTH. Sometimes I just talk more than everybody else. I am sorry to be self-serving here, but the building of those relationships with prosecutors all around the country is really, really key. In our experience, sometimes, when you would have a good case of fraud, and you bring it to a local prosecutor, when you mention the Commodity Exchange Act, and derivatives trading, their eyes glaze over, and they quickly lose interest.

So part of it is educational. And it is not just working with the individual prosecutors on individual cases, we are also part of an anti-fraud working group that the Justice Department puts together so that we can meet as a collective body frequently throughout the year, and try to educate them, because these cases—a fraud case is a fraud case—and we hope they are not deterred, because it can sometimes be a little bit arcane. We have made a lot of progress in that.

Mrs. KIRKPATRICK. Would more training for prosecutors help, is what you are saying? These are somewhat complex cases.

Mr. ROTH. We don't want them to panic at the phrase *derivatives trading.* It is fraud. And if you can get certain jurisdictions, like Chicago, they are very comfortable with these cases because they have done them. You just have to overcome those barriers in jurisdictions where they haven't brought as many cases.

Mrs. KIRKPATRICK. I have about 40 minutes left, any—I mean seconds left. Did anybody else want to comment: 40 minutes, I wish, Mr. Chairman: 40 seconds. Anyone else on improvements? Okay. I yield back my time. Thank you.

The CHAIRMAN. Thank you. Mr. LaMalfa.

Mr. LAMALFA. Thank you, Mr. Chairman. Of course, one of the key issues we are concerned with is the ability for end-users to have the access to the market, and the difficulty we are seeing with many of the rules that Dodd-Frank has offered, and CFTC is trying to sort out. But let me come back to Mr. Roth, and we will follow up with Mr. Corcoran too, on the issue of the number of FCMs that are available, that are in place, declining. And so, if you are concentrating more and more work, more and more risk, into fewer and fewer, that limits options for end-users, as well as everybody in the market. What problems does that really pose that we can hear today here in the Committee?

Mr. ROTH. Well, Congressman, that is an honest to God issue. Mr. Corcoran made a reference to the consolidation that has occurred over the last few years. If you go back—well, again, I started at NFA a long time ago. We had over 340 FCMs. So the consolidation has been dramatic——

Mr. LAMALFA. Three hundred forty?

Mr. ROTH. Three hundred forty.

Mr. LAMALFA. What do you think that number is today?

Mr. ROTH. Well, Jerry mentioned, it is about 73.

Mr. LAMALFA. Seventy three was it? Okay.

Mr. ROTH. And it is very scary because you are concentrating more risk in fewer firms, and if you take a look at your constituents, the number of FCMs that serve as ag producers, and ag end-users, that is a real small subset of the 73. So they have fewer and fewer choices, which isn't healthy for them from either their choices or their risk.

As regulators we have to be very, very sensitive to the regulatory costs that we impose with any sort of rule. Chairman Massad, I have had conversations with him on this topic, and I know he feels the same way. So, consolidation, when it is a result of business evolution and business competition, that is one thing. I never want to see the regulation having an undue impact on consolidation.

Mr. LAMALFA. Mr. Corcoran?

Mr. CORCORAN. Yes, thank you very much for this. It has been very difficult times for FCMs. As far as R.J. O'Brien goes, we are an independent FCM, so we are not owned by a bank affiliate or any other large corporation, so we have to make ends meet on our own. I would say that law, and compliance, and regulation has been a big, big investment of ours over the last 3 or 4 years the rules have evolved. And I would say many of the rules were tremendous rules when it came to customer enhancement and protection.

However, the burden of continuing compliance with the rules is ongoing, and we find ourselves investing millions of dollars in law and compliance in our organization just to meet, in some cases, very mundane regulation. But I would also add that it just isn't law and compliance that is a challenge to independent FCMs. It is technology investment as well. This industry has become very, very technology focused and intensive, and cybersecurity is now, obviously, a very, very important part of the food chain as well, and so it is difficult.

I don't see how we are going to get new participants in this industry, because it takes large scale to——

Mr. LAMALFA. Yes.

Mr. ROTH.—be able to cover the cost structures of an FCM today. And so what we want to do is make sure we don't lose any more FCMs, because the capital structure of FCMs is the foundation of this industry, and it is important not to lose any more members.

Mr. LAMALFA. Right. Thank you. Mr. Jackson, yesterday in our Subcommittee, amongst different subjects, was the hedge exemptions. We want to have *bona fide* hedge exemptions that—please talk a little about the process in the granting of those, but also please follow up too with the interpretation that is happening by CFTC of that. Is that a problem area, and do you think Congress should be intervening on that in helping to be more explicit on what a *bona fide hedge* is? Would you touch on those two things, please?

Mr. JACKSON. Yes. Thanks for the question, and the answer to your second question is yes. I think that Congress should get involved in making sure that what is being interpreted now in the rulemaking of the narrowing of what qualifies as a *bona fide* hedge is a deep concern to commercial market participants. And let me give you a very specific example. Just a couple of weeks ago I

brought around to the CTFC to meet each of the Commissioners a gentleman from Hershey's. So cocoa is one of the products that trades on our exchange.

You think about Hershey's. And what they were talking about in bringing forward to the Commission is the unintended consequence of a typical hedge that they do, a chocolate company, what are the times of the year where they make most of their money? They make most of their money selling products around Halloween, Christmas and the holidays, Easter, Valentine's Day. And when they negotiate contracts with the big shops, like, Walmart or Costco, they are negotiating those agreements 18 to 24 months in advance. And one of the interpretations that is being done to narrow it is that you can't hedge your risk, consumption or production risk, more than 12 months into the future. And for them Hershey Company is sitting here today negotiating contracts not for what a chocolate pumpkin is going to look like, and what it is going to be priced at for Halloween this year, they are talking about 2016 and 2017.

That is one example, as it relates to chocolate. You can go through, and I am sure Terry can do the same, and go through examples in every single one of our industries around what this narrowing definition of what constitutes a *bona fide hedge,* and what the material impact is going to be to standard practices that have been used for a long, long time. And at the end of the day, that means higher prices for consumers for these goods.

Mr. LAMALFA. So the flexibility you need to plan your product is taken away because of the short window?

Mr. JACKSON. Yes.

Mr. LAMALFA. Yes. Okay. Thank you. I had better yield back. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. We will get a second round of questions, if any of you have more questions. I have a couple for you, Mr. Bernardo. Someone suggested that laying futures market style rules over the unregulated swaps market was a mistake. Do you agree with this assessment, and how are swaps markets different from futures markets?

Mr. BERNARDO. I would agree that you can't take futures market regulation and lay it on top of the OTC derivative swaps market. The markets are very, very different. In futures you have a number of—a lot of clients trading much smaller amounts or sizes, and the the number of transactions per day is very, very high.

In the OTC swaps market, you have a number of—not as many clients trading very, very large sizes, and it trades much less frequently. You could have products that trade a couple of times in a week, you could have products that trade a couple of times in a month. So taking the regulation from futures and putting it into, and attempting to put it into the swaps market has not worked out very, very well.

The CHAIRMAN. You have commended the Commissioners for their willingness to consider potential revisions to its Dodd-Frank Act regulations. Could you please share with the Committee specific recommendations that a Commissioner has offered which you think should be implemented, and why that should be implemented?

Mr. BERNARDO. I think the fact that the Commissioners are willing to further review the rules, and realize the impact that some of the current regulations are having on the marketplace is terrific, and we welcome that. We have been working with staff over the past several years, and will continue to work with them on the issues that we are experiencing with the implementation of these rules.

The CHAIRMAN. The no action relief letters, and interpretive guidance, those types of things, compliance would—in those areas, I would think they would be pretty difficult to know——

Mr. BERNARDO. It is difficult——

The CHAIRMAN.—exactly what you were supposed to do.

Mr. BERNARDO. Agreed. It is the fact that it creates the uncertainty in the marketplace, and it creates instability, one, it will push what it can push, liquidity, offshore, which it has, because if we have prescriptive rules, which we currently have, what happens is you are dislocating the global financial markets, so liquidity that would have remained here in the U.S. is being pushed offshore. By that happening, inevitably, less liquidity in the market, the pricing is not as good, and inevitably the end-user is going to be impacted by that.

Euro interest rate swaps is a perfect example. I think in the past 15 months—has done a review of that particular market, and roughly 77 percent of that volume has moved offshore. So inevitably that is going to impact the end-user because less liquidity means worse pricing.

The CHAIRMAN. Thank you for that. I am going to yield the remainder of my time, and then I am going to go to Mr. Davis, allow him to ask questions, and then we will come back to Mr. Scott as well for a second round. Mr. Davis?

Mr. DAVIS. Thank you, Mr. Chairman. Thanks for having this hearing. It is great to see many of you on the panel again in front of this Subcommittee, and also when you appeared in front of our Committee, but your presence also means that there are still issues that we have to address as Congress, and that is why the testimony of each and every one of you today is extremely important to what we can do when we craft our proposal. So, with that, I will get right into the questioning.

Mr. Duffy, good to see you again, sir.

Mr. DUFFY. Nice seeing you, sir.

Mr. DAVIS. I want to ask about the issue of clearinghouse risk. Some market participants are calling for clearinghouses to increase their contribution, or their skin in the game, to the so-called default waterfall in the event of a clearing member default. For the benefit of the Committee, can you describe to us what sort of cost impact an increased contribution requirement would have on your clearinghouse, or any clearinghouse?

Mr. DUFFY. Well, today we already do have a contribution to our default fund. We have the largest contribution of any exchange in the world. We are roughly around $400 million of our money into that default fund. And it also comes before any of the clients, so if there was a default, it is the default, the client, the CME, and then it comes to the clients behind them, so we are in front of all the other clients.

What is interesting about some of the calls for increased skin in the game, as they are referring to it, Congressman, is it could cause a bunch of different issues. First of all, we don't introduce risk as exchanges, we manage risk as exchanges, so we don't bring it, we manage it. There is an inherent difference right there about how we should have it. You have to look at the entire regulatory regime that we operate under. Chairman Massad said it well in a recent speech, there is more to skin in the game than the whole regulatory regime.

The other thing that always concerns me about when you put more skin in the game is always there is a potential moral hazard. So if I was to put up more money, and you were able to trade bigger against my dollars, does that induce you to act in bad behavior because you are not putting your funds at risk, you are putting my funds at risk first? That is a concern. That is a moral hazard. That is a moral hazard to the other participants that are in the default fund below me also.

So these are all things that are very concerning when people call for this, just saying that they should—CCPs, or clearinghouses, such as ours or the IntercontinentalExchange, should have more skin in the game. We have, as I said, close to $400 million today. We think we have adequate skin in the game. We don't introduce risk, and this would put a huge burden on our system, because we don't even know what the number people are saying is, "Put more into that system is."

Mr. DAVIS. Thank you, Mr. Duffy. Mr. Corcoran, I had a brilliant question set up for you, but somebody else asked it, so you got a——

Mr. CORCORAN. Am I off the hook, then?

Mr. DAVIS. You are off the hook. I am actually going to go back to Mr. Duffy. So, Terry, yesterday we had a hearing in this Subcommittee, and an end-user witness testified that he believed futures exchanges were opposed to position limits because such limits would reduce trading volume, and therefore an exchange's revenue. Is there any merit to this claim?

Mr. DUFFY. No, absolutely not. Futures exchanges are not opposed to position limits. Matter of fact, today, sir, we have hard limits on all of our agricultural products because they are government mandated. On our energy contracts we have hard limits in a spot month to make sure that we manage—so there is no congestion, and then we have accountability levels. So for someone to say that we would be opposed to position limits because we want to put the trade in front of the credibility of the marketplace is ridiculous.

I have said this since I have been Chairman of this firm, for 14 years, if we don't have a credible marketplace, we don't have a company. And that is the most important factor to the CME group, and me as the Chairman and President of the firm, that I will always say throughout the organization. We put nothing in front of the credibility of our marketplace, and position limits and accountability levels are a component of that.

Mr. DAVIS. Well, thank you. And, Mr. Jackson, you run a futures exchange. What is your response?

Mr. JACKSON. Thank you. I would echo a lot of what Mr. Duffy said, as he is spot on there, at the end of the day, one of the most

important roles that we have as exchange operators is to make sure that our futures contracts facilitate convergence, convergence for the futures price to where the physical prices are. So we are incented to not have manipulative activity going on. We are incented to have an orderly market. And, like Mr. Duffy has position limits in place, we do as well at the IntercontinentalExchange.

Mr. DAVIS. Well, thank you very much. Thank you to each and every one of you. Again, great to see many of you again, and I yield back the balance of my time, Mr. Chairman.

The CHAIRMAN. Four seconds, thank you. Mr. Scott.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman. Over a period of time we have had this issue of the definition of *U.S. person,* dealing with cross-borders. I mentioned in my opening remarks this derivatives swaps market is global. And about a year and a half ago, it was in July of 2013, the CFTC issued its final guidance, setting out the scope of the term *U.S. person,* the general framework for swap dealer and MSP registration determinations, the treatment of swaps involving certain foreign branches of U.S. banks, and the treatment of swaps involving a non-U.S. counterparty guaranteed by a U.S. person, or affiliate conduit.

Now, I would like to get your thoughts on this definition of *U.S. person.* How have you all, and the market itself, been affected by the Commission's guidance defining who is a *U.S. person?*

Mr. BERNARDO. I guess I will start on that. And to your point, Congressman, the markets are global, so by having a distinction between a U.S. person and a non-U.S. person, what we have experienced is an impact on the liquidity in the marketplace, and what we have seen is clients and/or firms that are also global, and have a U.S. presence as well as presence overseas, they will opt to do business under a less prescriptive regime in Europe and/or in Asia.

And we have seen that happen across multiple products, and we have actually been told by those very customers that the reason they are not trading in the U.S. with us at this point is because the rules are less prescriptive away. So the markets are global, as you said, and inevitably you are dislocating the marketplace. So those liquidity pools that were operating 24 hours, and the U.S. looked upon as one of the liquidity pools where they could get business done, they——

Mr. DAVID SCOTT of Georgia. Yes.

Mr. BERNARDO.—now choose to do that business overseas.

Mr. DAVID SCOTT of Georgia. And so, going forward, what recommendations could you make to the CFTC to give greater clarity on this whole definition of *U.S. person?* It just keeps coming up.

Mr. BERNARDO. I think it is important not to just do it for the definition of *U.S. person* or *non-U.S. person.* It is important that the rules overall are flexible. So if we have flexible rules in the U.S., as we currently do overseas, you wouldn't see as much liquidity move away from our shores, which inevitably will hurt the U.S. economy. It will take away jobs. I think that the staff, although working very, very hard as it is now, needs to consider more flexible rules, which, again, we welcome.

Mr. DAVID SCOTT of Georgia. All right. Thank you. Let me ask the panel: there comes up, all the time, about enforcement and the CFTC, many complaints that any enforcement action of the Com-

mission have yet to produce any prosecutions for senior managers of any of the major financial firms that have been engaged in misconduct. There is public awareness, and public pressure that, with all that has happened within this area since the meltdown of our financial system, and there has been wrongdoing, but there is been no prosecution. No one has gone to jail. And you all have heard that as well. So let us weigh in on that.

How much are the Commission's enforcement action seen, for example, as the cost of doing business, and how do we rectify this situation? How do we improve the enforcement strength of the CFTC?

Mr. ROTH. Thank you. I think the CFTC's enforcement program has been very vigorous, obviously, over the last several years. And you are right, and a little discussion we had earlier just mentioned that, from my point of view, the ultimate deterrent to violations of rules, where it involves fraud, is legal enforcement action, prosecutions. Criminal prosecutions have infinitely more impact, from a deterrent point of view, than civil sanctions.

Now, the CFTC has the authority to bring civil actions, but obviously they have to work with criminal prosecutors to bring those types of criminal prosecutions. And, obviously, those burdens are difficult. It is intentionally a difficult burden to prove, to deny somebody their liberty. I am not privy to the proof the Commission has in those cases, but I know that their overall sentiment is to build the strongest case they can, and work with prosecutors to achieve prosecution where they can, and—but those——

Mr. DAVID SCOTT of Georgia. Yes.

Mr. ROTH.—there is inherently a difficult burden of proof in bringing a criminal case.

Mr. DAVID SCOTT of Georgia. The personal liability regime for a senior manager, for example, at a clearing members who do nothing to stop reckless manipulative behavior on their watch? Now, in England right now they are setting a rule that they are contemplating to deal with a situation like this. Are you all aware of that?

Mr. DUFFY. Congressman, I am aware of the failure to supervise, and that is kind of what you are referring to here a little bit, what some of the FCMs have done historically, and we have seen charges brought against FCMs historically over the last 20 years against failure to supervise, even when they have people out in the country that they are supposed to be overseeing, which sometimes they don't have a hands-on ability. Mr. Corcoran, obviously, has a lot of offices throughout the country. He has to supervise those, and he has an obligation to do so.

It is a very difficult process, but I do think we are seeing the enforcement of the CFTC, to Mr. Roth's point, take hold, when you look at what happened at Peregrine Financial, when you look at what happened in other instances. But the public, to your point, is looking for someone to stand up and accept blame, and someone has to put them in jail. So whether it would happen with MF Global, whether it has happened with the fixing of LIBOR, foreign exchange, and every other benchmark, what is going to happen with this?

And I am not a prosecutor, I don't know. I think Mr. Roth is right, it is a little out of the CFTC's realm, and they need to work with the government to prosecute these people.

The CHAIRMAN. I need to move on to the next round of questions, if we may. Mr. Davis.

Mr. DAVIS. Mr. Corcoran, my brilliance is back. I found a question for you. You have expressed concern regarding the U.S. and foreign regulators' failure to coordinate the regulation of your markets. Do you believe that dual registration and cooperative oversight is a viable means to regulate clearinghouses?

Mr. CORCORAN. Dual registration is not necessary, in my opinion. Mr. Duffy and Mr. Jackson are better suited to speak to this, but it seems that we are very, very close to solving the equivalence issues, and it has boiled down to how we collect margins from customers. Just the recognition that each of the jurisdictions have adequate safeguards for CCPs, it should be able to recognize the ability to get this done.

Mr. DAVIS. Yes. Okay. Does the CFTC staff's use of letters to issue individual exemptions to a limited number of foreign clearinghouses provide enough clarity and certainty to market participants? Is there a better solution?

Mr. CORCORAN. Not necessarily. These letters do not provide absolute certainty to the participants on a going forward basis, and sometimes come far too late for the market participants to anticipate approval or non-approval. And so it is better to be done at the senior levels of the regulatory regimes, and get this done without letters.

Mr. DAVIS. Okay. Well, thank you. Actually, we will start with Mr. Roth, and then, Mr. Duffy, if you would like to jump in, and Mr. Jackson too, obviously the CFTC is an agency that we know. We have to go through the reauthorization process, and part of our job as policymakers is to ensure that any mandates that are imposed by us are working correctly.

And, in an effort to help free up some resources at the CFTC, we are—Congress—we are able to eliminate mandates that may not be necessary, and shift more responsibilities to more appropriate parties, like yours, Mr. Roth. Are you aware of any obligations that Congress has required of the CFTC, or what they have undertaken which may no longer be needed?

Mr. ROTH. Congressman, what we have been doing, in conversations with Chairman Massad, and with the Commission staff, and with the CME, is trying to identify those situations where there are activities that are being performed by both the CFTC and NSRO, whether it—involving reviewing monthly financial statements—there is a myriad of activities that the CME and NFA both engage in on a daily basis, and the Commission staff expends resources in those areas as well.

And what we are trying to do is eliminate duplication of effort, and that is multifaceted. It is not just between the CFTC and NFA, or the CME. It is also in the swaps area, for example. We are trying to coordinate with other—so many of our swap dealer members are banks, regulated by several different bank regulators. We are trying to coordinate activities with them so that we don't duplicate efforts.

No matter how we fund the CFTC, regulatory resources are always going to be precious, and we can't afford to duplicate efforts when we can avoid it. And so we are trying to work with the Com-

mission to eliminate that. We are trying to work with bank regulators to achieve the same goal.

Mr. DAVIS. Has Chairman Massad been cooperative in reducing some of these duplicative efforts?

Mr. ROTH. He is been more than cooperative. He has initiated the discussions, in some cases.

Mr. DAVIS. Great.

Mr. ROTH. I mean, he is certainly aware of the constraints on his budget, and looking for creative ways to deal with them. We have had a great working relationship.

Mr. DAVIS. Thank you. Mr. Jackson?

Mr. JACKSON. To add another—when it goes to the interpretation of what is the role of the CTFC, especially in granting hedge exemptions for non-enumerated commodities, in the proposed rules, now the CFTC would take that responsibility away from the exchanges, like mine, and from Mr. Duffy's exchange.

In the comments that I made up front, the decades of experience it takes in working and interfacing with each one of our commodity market participants to understand the nuances of each one of those, it is a big undertaking that the CFTC would need to undertake to ensure that they are not disrupting a commercial entity's ability to hedge in a timely manner by taking on that responsibility. And, by doing that, they are going to need more funds, and substantially more staff, if that is the way this lands, as opposed to the way it works today.

Mr. DUFFY. If I could just add real quick, Congressman, two things. I will say something that former Chairman Frank said in the Financial Services Committee to me one day several years ago. He asked why should the exchanges have a DSRO at all? I said, we have to have a DSRO to do the risk management. So even if you gave it to somebody else, you will duplicate the cost, because we are going to do it just for the risk management needs. So there is certain proposals that Congress, or a government agency, may think of that somebody else should do, and not us, that adds a burden of cost to the government that doesn't need to happen—that has not happened.

Second of all, on the position limits regime is a great example. We have the expertise—these position limits—it goes back to your earlier question. The credibility of our institutions are out there, for everybody to see. We need to make sure that we continue to manage this position limits issue, and do it in an effective way that takes the burden away from the government, and the cost away from the taxpayer.

Mr. DAVIS. Thank you. My time has expired.

The CHAIRMAN. Mrs. Kirkpatrick.

Mrs. KIRKPATRICK. Mr. Bernardo, I want to follow up on your statement earlier about the fact that clients and customers are going to other countries, rather than staying in the U.S. market. Can you expand a little bit more specifically for me on why that is happening?

Mr. BERNARDO. Well, it is happening for several reasons. One, because of the prescriptive nature of the execution rules that are in place——

Mrs. KIRKPATRICK. Is that the CFTC rules——

Mr. BERNARDO. Correct.

Mrs. KIRKPATRICK.—primarily? Okay.

Mr. BERNARDO. Because of the uncertainty that is been created, and the constant letters that are coming out from the CFTC staff, it makes it very, very difficult for them to consider executing in our marketplace, going forward, as opposed to going overseas, where the regulation is not as stringent, or not as prescriptive, or if they want to be considered a swap dealer, or whatever the case may be, they are going to go and execute their business where the rules and the regulations are much more flexible. So, by having prescriptive rules, we are actually pushing business offshore.

Mrs. KIRKPATRICK. What would be your top three recommendations to this Committee of something we could do to help level the playing field for our companies?

Mr. BERNARDO. I think the top thing to do is to what has been said that we are going to do, which is they are going to look at the rules again and create more flexible rules so you can take some of that uncertainty and instability out of the marketplace.

Mrs. KIRKPATRICK. Anyone else want to compliment that? Ideas about how we can make our companies more competitive? Could you give me some examples of what kind of flexibility you would like to have in the CFTC rules?

Mr. BERNARDO. For instance, to continue to follow the interstate commerce rules, where your means of execution are flexible. There are multiple modes of execution that we currently use now. If you limit those modes of execution, you could limit the innovation that is to come in years to—years ahead of us.

So right now we use voice, electronic, and hybrid means of execution. We use auction platforms, algorithmic matching engines to transact business. If you tie prescriptive rules around those execution modes, we are going to hurt innovation, and, inevitably you will hurt liquidity.

Mrs. KIRKPATRICK. Okay. Thank you for offering us this guidance, and I look forward to working with you as we go through this process to make it better. Thank you very much. I yield back.

The CHAIRMAN. Thank you. And before we adjourn, I invite the Ranking Member to make any closing remarks he has.

Mr. DAVID SCOTT of Georgia. Well, thank you, Mr. Chairman. This has been a very interesting and very important hearing for us all. We look forward to putting together our legislation coming up that will be very similar to H.R. 4431. We have many, many issues to deal with, to grapple with, to make sure we are clear. We have the cross-border, we have to work with the areas in getting the SEC and the CFTC to jointly rule appropriately. And, of course, as I mentioned before, we want to keep our eye on making sure the appropriations level is there for the CFTC.

And as I said at the very beginning, you all out there, CME, ICE, all of the exchanges, the clearinghouses, you are the guys on the playing field, and we are more like the referees and the umpires here, so we have to work together. We look forward to it. And, Mr. Chairman, it is a pleasure working with you on this Committee, and we look forward to moving this issue, and handling Section VII of Dodd-Frank with good progress moving forward. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. I want to thank all of you for coming. These are complex issues, and, as you have said, the integrity of the markets are extremely important to you. They are extremely important to us. We need the people who are using those markets to believe in them. And so, as we work to balance that integrity, and access of those markets, we will be continuing to rely on experts like yourselves for that input.

I think that, and I have every hope that we will have a very good piece of legislation that will be bipartisan that will be allowed to move through the House of Representatives, and hopefully through the Senate that reaches that balance between access and integrity.

With that said, under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional materials and supplementary written responses from the witnesses to any questions posed by a Member. This Subcommittee on Commodity Exchanges, Energy, and Credit hearing is now adjourned.

[Whereupon, at 3:05 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED QUESTIONS

Response from Hon. Terrence A. Duffy, Executive Chairman and President, CME Group

Questions Submitted by Hon. Austin Scott, a Representative in Congress from Georgia

Question 1. Mr. Duffy, under the CFTC's proposed Position Limits rule, several current methods of *bona fide* hedging will no longer be available to market participants. What is the impact of limiting *bona fide* hedging exemption beyond what has been available in the past? Does this interject risk into the hedging plans of end-users?

Answer. Yes, the Agency's currently-proposed *bona fide* hedging exemption would force a dramatic step back from historical market practices by disallowing many reasonable commercial hedging strategies. By limiting the exemption to a rigid and narrow list of enumerated hedges, the Agency's proposal threatens to inject considerable risk into commercial operations.

There is no evidence that Congress intended for the Agency to make it more difficult through position limits rules for farmers, ranchers, and other commercial end-users to hedge their price risks. In fact, this aspect of the Agency's proposal is directly at odds with the CEA's stated purpose of promoting "sound risk management" and Congress' clear intent that CEA section 4a(c)(2) was intended to *preserve* a hedger's pre-Dodd-Frank risk management tools.[1]

CME Group supports allowing exchanges to administer non-enumerated hedge exemptions that meet the statutory criteria. This is consistent with current practices and would alleviate the Agency from needlessly tying up its limited resources responding to requests for non-enumerated hedge exemptions. Many market participants that would need to rely on non-enumerated hedges are already familiar with these practices, meaning fewer market disruptions should be expected from hedgers being forced to exit the markets or having to fundamentally remake their businesses and hedging practices due to the sudden inability to use existing commercially-reasonable risk-reduction strategies.

Rather than refuse to give commercial end-users the latitude to continue using reasonable commercial hedging practices for fear that a few bad actors could abuse the system, the Agency should rely on its special call and anti-evasion authorities to enforce the limits.

Question 2. Mr. Duffy, the CME has important obligations as an SRO. Can you share with the Committee what those obligations are? How do you ensure that your regulatory obligations are not influenced by the need to make money for shareholders?

Answer. The regulatory structure of the modern U.S. futures industry involves a comprehensive network of regulatory organizations that work together to ensure the effective regulation of all industry participants. The Commodity Exchange Act ("CEA") establishes the Federal statutory framework that regulates *the trading and clearing* of futures and futures options in the United States, as well as swaps other than security-based swaps (which fall under the regulatory purview of the Securities Exchange Commission), pursuant to Dodd-Frank. The CEA is administered by the CFTC, which establishes regulations governing the conduct and responsibilities of market participants, exchanges and clearinghouses.

Thus, the SRO construct no longer consists solely of a single entity governed by its members regulating its members; rather, exchanges, most of which are public companies, oversee the market-related activities of all of their participants—members and non-members—subject to corollary oversight by the CFTC and National Futures Association ("NFA").

Moreover, an exchange's ground-floor vantage point into its markets provides a unique level of expertise that the CFTC alone is not equipped to have. Direct regulation by the exchange offers our regulators unique proximity to the markets, market participants and the broader resources of the exchange in ways that foster the development of expertise that not only helps to make our regulatory staff more effective, but also assists Federal regulators in our common objective of preserving the integrity of the markets. Exchange sponsored regulation also allows for more expe-

[1] *See, e.g.,* Floor Statement by the Hon. Frank D. Lucas, Ranking Member, House Com. On Ag., *Re:* H.R. 4173, the Wall Street Reform and Consumer Protection Act (Dec. 10, 2009) ("[W]e were able to improve areas most important to end-users—the manufacturers, the energy companies and food processors that use swap agreements to manage price risk so they can provide consumers the lowest cost products"); Letter from Sen. Christopher Dodd and Sen. Blanche Lincoln to Rep. Barney Frank and Rep. Colin Peterson (June 30, 2010) (cautioning the Commission to "not make hedging so costly it becomes prohibitively expensive for end-users to manage risk").

dient identification of potential issues given our knowledge of and proximity to the markets, as well as the ability to react more quickly and flexibly to potential market and regulatory issues.

The financial incentives of SROs also benefit the safety and soundness of the markets which they oversee. Effective SRO regulation is necessary to ensure that an exchange clearinghouse that is required to have "skin in the game" does not have to tap into these reserve funds in the event of a member default, which would in turn harm shareholders.

To accomplish this, exchanges devote substantial resources to their self-regulatory responsibilities and programs. Also, the exchanges have established a robust set of safeguards to insure these functions operate free from conflicts of interest or inappropriate influences. CME alone spends more than $40 million annually carrying out, adapting and improving its regulatory functions, which includes employing over 200 financial regulatory, IT, and surveillance professionals.

Question 3. Mr. Duffy, in reference to the position limits rule, former Commissioner Dunn said "no one . . . presented this agency any reliable economic analysis to support either the contention that excessive speculation is affecting the market we regulate or that position limits will prevent the excessive speculation." Do you share Commissioner Dunn's views?

Answer. CME Group shares the Agency's regulatory mission of ensuring liquid, fair and financially secure markets.

For many years, CME Group has supported and imposed speculative position limits for physical commodity contracts in the spot months based on a formula grounded in CFTC-accepted estimates of deliverable supply. We recently sent our updated and preliminary 2015 estimates of deliverable supply for core referenced futures contracts to the Commission for acceptance. We have also applied position accountability limits outside the spot months as an effective tool in balancing regulatory concerns over market congestion and manipulation with the need to facilitate liquidity in the out months in order to support price discovery and risk management functions.

The Agency's proposal begins with a CFTC statutory interpretation finding that Congress mandated the imposition of physical commodity position limits even if unnecessary to prevent the supposed burdens associated with excessive speculation. When considered closely, the Proposal does not cite any evidence that Congress intended to mandate the CFTC to impose limits that the CFTC believed to be unnecessary. The law is clear that, since 1936, position limits for a commodity contract could not be imposed unless the regulator found them to be "necessary."[2] In Dodd-Frank, Congress did not amend that statutory requirement. Absent evidence of unambiguous Congressional intent to repeal by implication that longstanding "necessary" finding requirement as it relates to physical commodity derivatives, the requirement still stands.[3]

At a minimum, the CFTC's regulations, unlike the current proposal, must establish a framework that promotes the public interest purposes of CEA section 4a—to prevent and deter excessive speculation and manipulation while ensuring sufficient liquidity for *bona fide* hedgers, and protecting price discovery in the underlying benchmark futures contract.

As the Agency is currently considering public comments on these proposed rules, we encourage careful consideration of the following issues:

Establishing Federal Spot Month Limits

CME Group continues to believe that the Agency cannot set necessary and appropriate Federal spot limits unless it applies the most current deliverable supply estimates available. The Commission should rely upon current, up-to-date deliverable supply estimates from the exchange listing the physical delivery contract where available and acceptable. The exchange listing the physical delivery contract had the most direct knowledge of the factors described by the Commission as relevant to calculating deliverable supply, and has been making those calculations for decades as part of their own exchange-administered position limit program.

Once a deliverable supply baseline has been identified, we agree with prior Commission statements that speculative position limits should "be based upon the individual characteristics of a specific contract market."[4] Consistent with past policy, the Agency should not impose spot month limits based on an absolutist approach to the 25% of deliverable supply formula across all referenced contracts. No sound

[2] CEA section 4a(a)(1); 7 U.S.C. § 6a(a)(1).
[3] See *Hunter* v. *FERC,* 711 F.3d 155, 160 (D.C. Cir. 2013).
[4] See *Revision of Federal Speculative Position Limits,* 52 FED. REG. 6812, 6815 (proposed March 5, 1987).

economic theory or analysis supports such a uniform approach. Rather, the Agency should use 25% of deliverable supply as a ceiling and work with the exchange(s) listing the physical-delivery benchmark contract to set the Federal spot-month level below this ceiling on a contract-by-contract basis, recognizing the unique market characteristics of each commodity that is traded.

Limits for physical delivery and cash-settled "look-alike" contracts should be equal for the same underlying commodity. The proposed conditional limit exemption for cash-settled contracts threatens to drain liquidity away from the physical delivery markets to the cash-settled markets during the spot month as contracts approach delivery, thus causing harm to the price discovery process and opening the door to potential market misconduct. The Agency should not seek to artificially tip the scale in favor of cash-settled markets and increase the risk of possible price manipulation or distortion.

Administering a Position Accountability Regime

Position accountability levels should apply in lieu of hard limits outside of the spot month for non-legacy agricultural commodity derivatives. Nothing in the Agency's statute or any legislative history should foreclose the possibility of using this more flexible position accountability approach in the out months as a reasonable alternative to Federal hard cap limits. Such an approach would better serve market integrity and protect the price discovery process in the out months when diminished liquidity can have a severe negative impact. Exchanges have successfully relied upon accountability levels for decades to safeguard against market congestion and abusive trading practices. Based on this experience, exchanges are well positioned to partner with the Agency to administer a Federal position accountability program, thus preventing any further drain on the Agency's limited resources.

Administering Non-Enumerated Hedge Exemptions

As referenced in my response to *Question 1,* CME Group believes the Agency should provide exchanges with discretion to administer non-enumerated *bona fide* hedge exemptions in core referenced futures contracts, consistent with their current practices. Many market participants that would need to rely on non-enumerated hedges are already familiar with these practices, meaning fewer market disruptions should be expected from hedgers being forced to exit the markets or having to fundamentally remake their businesses and hedging practices due to the sudden inability to use existing commercially-reasonable risk-reduction strategies.

Under such an approach, the Commission could instead focus its limited resources on enforcement efforts that utilize existing special call and anti-evasion authorities.

Response from Benjamin Jackson, President and Chief Operating Officer, ICE Futures U.S.

Questions Submitted by Hon. Austin Scott, a Representative in Congress from Georgia

Question 1. Mr. Jackson, recently, the Committee heard Chairman Massad testify about his concerns over the supplemental leverage ratio. Chairman Massad said: "I am very concerned that this [the supplemental leverage ratio] could have a negative effect on clearing." Do you share his concerns? What do you foresee as the result of regulators continuing to penalize bank FCMs for holding margin?

Answer. I share Chairman Massad's concern over the supplemental leverage ratio as part of the Basel III standards and consider it a major problem for clearing members and their customers. While Dodd-Frank implementation continues, and our banking system works to comply with Basel standards, futures market customers continue to be hit with multiple, new compliance costs and risks for simply accessing these markets as necessary to hedge exposures to price risk. The current SLR interpretation is a great example of this cost increase.

These markets serve critical hedging needs for many of your constituencies, and I worry that they could be hit especially hard with additional costs and less choice in clearing should firms ultimately bear the cost of compliance with the current SLR proposal. Under the current proposal, banks have a dis-incentive to provide directional hedges to their customers because of high capital charges for doing business with commercial hedgers. This could easily lead to negative outcomes that we, along with most commercial participants, would hate to see. As for the results of this proposal; should its current interpretation continue, we will see an exacerbation of the negative trends we hear and read about today: fewer FCMs , higher costs and more incentive not to clear.

Question 2. Mr. Jackson, you believe the CFTC should return to a system where it relied on "foreign regulators to regulate foreign transactions" and it "worked with regulators to adopt common principles that all regulated markets should adopt."

How is that different than the process the CFTC is currently pursuing? What are the implications of the regulatory strategy it is pursuing?

Answer. Historically, the CFTC exempted transactions on foreign markets and relied on foreign regulators to regulate their own markets. For example, in 1996, the CFTC allowed Eurex to offer direct access to its futures markets.[1] In doing so, the CFTC relied upon Eurex's regulators, whose oversight the CFTC saw as comparable to U.S. regulation because they recognized the IOSCO Principles for Oversight of Screen-Based Trading Systems for Derivatives Products. This openness led to great market innovations such as electronic trading and clearing of OTC derivatives. At the same time, relying on foreign regulators was far more efficient for the CFTC.

Historically, the CFTC exempted transactions on foreign markets and relied on foreign regulators to regulate their own markets. For example, in 1996, the CFTC allowed Eurex to offer direct access to its futures markets. In doing so, the CFTC relied upon Eurex's regulators, whose oversight the CFTC saw as comparable to U.S. regulation because they recognized the IOSCO Principles for Oversight of Screen-Based Trading Systems for Derivatives Products.[2] This openness led to great market innovations such as electronic trading and clearing of OTC derivatives. At the same time, relying on foreign regulators was far more efficient for the CFTC.

Dodd-Frank greatly changed this dynamic by extending U.S. regulation internationally. In addition, the CFTC issued its rules earlier than other jurisdictions; for example, the CFTC's clearing rules[3] came out before the IOSCO Principles for Financial Market Infrastructures.[4] Finally, U.S. and international regulators put in more prescriptive rules, where, historically, derivatives regulators had used a principles based approach. The timing gap and the more prescriptive approach have forced regulators to harmonize their rules line by line, lest they leave room for regulatory arbitrage.

We can see the implications now, as U.S. and European regulators work to harmonize their clearing rules. The process has taken nearly 2 years and costs thousands of hours of time spent by U.S. and EU regulators working through this one issue. Importantly, this is just one of several issues that U.S. and EU regulators will have to harmonize.

Question 3. Mr. Jackson, you run a futures exchange that has long imposed position and accountability limits on your contacts. In your view, what is the purpose of exchange imposed limits? How does an exchange's use of position and accountability limits differ from what the Commission is trying to accomplish?

Answer. Currently, the Exchange imposes spot month position limits in all contracts[5] and position accountability for non-spot months. Single month and all month position limits currently exist for certain agricultural and stock index products.

The CEA grants the Commission discretion to adopt accountability levels rather than hard limits with respect to non-spot months. Exchanges have successfully used position accountability levels for over a decade to deter excessive speculation and manipulation while allowing the markets to continue to serve their price discovery and hedging purposes in non-spot months.

Position limits and accountability levels are two of many functions that an Exchange employs to ensure that markets operate orderly and are not subject to undue influence. Where position accountability differs from position limits is that it allows an Exchange to proactively require a market participant to reduce a position not established in accordance with sound commercial practices or that may have a negative impact to the market. Conversely, accountability levels allow positions to be maintained if they are established in an orderly manner and are positively contributing to the price discovery function. A position limit regime is static and simply disallows positions to be greater than a predetermined amount. The Commission has not suggested that accountability levels are ineffective at deterring excessive speculation or manipulation. Moreover, it is widely acknowledged, including by the Commission, that the threat of manipulation outside of the spot month is greatly diminished. Accordingly, the current regime, with spot month position limits and non-spot month accountability levels, successfully achieves liquidity across many contract months while helping to ensure orderly expirations.

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[1] *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/99-48.pdf.*

[2] *http://www.iosco.org/library/pubdocs/pdf/IOSCOPD4.pdf.*

[3] *http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-27536a.pdf* (November 8, 2011).

[4] *http://www.bis.org/cpmi/publ/d101a.pdf* (April 2012).

[5] With the exception of certain futures based on major foreign currencies, stock indices and natural gas options, which are exempted under Commission Regulations.

Question 3a. In your testimony, you comment that the implementation of limits in any month may "concentrat[e] volume and liquidity toward the prompt delivery months only." Why is that a problem?

Answer. The implementation of hard position limits in any single month and all months combined will potentially reduce liquidity in every month because traders that currently hold positions in excess of the limit will be forced to reduce them unless the positions meet the very stringent proposed definition of *bona fide hedging.* Traders could potentially hold positions equal to the all months combined limit in the front month, where liquidity is concentrated, and consequently would not be permitted to hold a position on the same side of the market in a contract month further in the future because doing so would cause them to exceed the all months position limit. In such case, liquidity and volume will be reduced in those more distant contract months as firms are forced to choose between taking positions in spot and distant months. Many commercial market participants (producers, end-users and merchants) in Exchange markets currently employ risk management programs that require hedging positions in contract months that are further in the future. For example, sugar cane plants have a 3–6 year life cycle and producers need to manage their risk beyond 12 months of production, which requires establishing hedges in back months. Implementing position limits in such months will restrict needed liquidity and as a result, commercial market participants may find that their risk management programs are less effective. In addition, the price discovery function of the markets could be negatively impacted. This is important because the prices of the contract months that are further out the curve provide critical information to producers, for example, that may be making planting decisions based on such prices.

Question 3b. Are there other market disruptions that may result from CFTC imposed position limits?

Answer. The proposed rules will prevent commercial market participants from using many of the risk management strategies employed for years and that have not been detrimental to the market. The risk management strategies that are not recognized by the proposed rules include establishing positions to manage the risk of unfixed price commitments, anticipatory hedging beyond 12 months of unfilled anticipated needs and unsold production and anticipated merchandizing. The failure to recognize these strategies as *bona fide* hedging could significantly disrupt the markets as positions are required to be reduced, resulting in less liquidity and a less effective price discovery function.

While the Commission has indicated that market participants may apply for non-enumerated hedge exemptions, if it cannot provide a timely response to such exemption requests, then uncertainty will be created for market participants as they will not know if they can continue to use the risk management strategies that they have used successfully for years. The Exchange has recommended that the current structure—whereby the Commission oversees certain domestic agricultural commodities while the listing exchanges oversee their other products—reflects an efficient allocation of responsibility and resources that ensures commercial market participants will continue to be able to manage their risks in a timely manner.

Response from Daniel J. Roth, President and Chief Executive Officer, National Futures Association

Question Submitted by Hon. Austin Scott, a Representative in Congress from Georgia

Question. Mr. Roth, in your testimony, you stated that the NFA is working with the CFTC to determine the extent of NFA's responsibilities to monitor foreign firms that the CFTC has allowed to comply with comparable rules from their home jurisdiction. Could you please elaborate on the NFA's oversight of foreign firms?

Answer. To provide some background, NFA has a little over 4,000 members, about 600 of those members are non-U.S. firms. NFA monitors all of its members (both U.S. and non-U.S.), for compliance with its rules and applicable CFTC regulations. The monitoring program includes financial analysis, investigations, exams and many other oversight functions.

However, we should note that the scope of NFA's responsibilities in the substituted compliance regime that has been established for swap dealers remains unclear. About 50% of NFA's 103 swap dealer members are non-U.S. firms. Questions have been raised as to whether NFA would be required to monitor swap dealer members for compliance with the rules of foreign jurisdictions. Given that the CFTC has found certain rule areas of six jurisdictions to be sufficiently comparable to permit substituted compliance, presumably the foreign regulator would be responsible for monitoring for compliance with those local laws. We continue to discuss with the CFTC an approach to oversight of non-U.S. SDs that is both meaningful and practical.

Response from Gerald F. Corcoran, Chairman of the Board and Chief Executive Officer, R.J. O'Brien & Associates, LLC; on behalf of Futures Industry Association

Questions Submitted by Hon. Austin Scott, a Representative in Congress from Georgia

Question 1. Mr. Corcoran, in your testimony, you commend the CFTC for its efforts to determine the appropriate residual interest deadline. But, in its final rule, the CFTC left the door open to revisit the issue. Do you believe that a statutory fix, such as the one included in H.R. 4413, is still necessary? Why?

Answer. The CFTC, under Chairman Massad's leadership, recently took the necessary steps to ensure that any abbreviated residual interest deadline be subjected to a thorough public review. The recently finalized rule amends Commission Regulation 1.22 by removing December 31, 2018 as the automatic termination date of the phased-in compliance period which would have resulted in an earlier residual interest deadline. As a result, the deadline will remain 6:00 p.m. Eastern Time pending the possibility of future Commission rulemaking. The statutory directive included in previously passed House legislation would ensure that any future rulemaking not further condense the deadline.

Question 2. Mr. Corcoran, we have heard a lot about position limits this week. Do you think the exchanges do a sufficient job of setting and policing position limits in their markets? Are speculators necessary for derivative markets? Are there potential consequences to reducing their ability to transact these markets?

Answer. Because the exchanges are close to the products and monitor all of the activity on their markets, they are well-suited to police for position limits. In particular, the exchanges have a long history of managing accountability levels in the non-spot month by monitoring positions when they approach the levels and working with the trader if the position needs to be reduced. They also have managed well the process for granting certain *bona fide* hedge exemptions, also by relying upon their knowledge of markets and market participants. We have recommended that the CFTC continue to rely on the exchanges to manage accountability levels and police position limits.

Liquid markets are the most successful markets. Restricting one class of market participant beyond what is necessary to address excessive speculation can have an impact on markets by restricting liquidity required by those *bona fide* hedgers needing to lay off risk. Often speculative traders will be the most natural buyer to a *bona fide* hedger in a seller position. If regulations unnecessarily reduce a speculators ability to transact in the market, it can impact a *bona fide* hedger's ability to transact in that same market by reducing the number of potential counterparties in that market.

Question 3. Mr. Corcoran, why are last-minute CFTC "no-action" letters issued on the eve of arbitrarily set deadlines not helpful from a regulatory compliance standpoint? Does the uncertainty cost your companies or member firms valuable capital?

Answer. Prudent regulatory compliance requires market participants to make informed business decisions, long prior to the effective date of any regulation. No-action relief granted just prior to the compliance date of any regulation thereby creates an enormous amount of inefficiency as those subject to the regulation are forced to make implementation decisions even as questions remain about their compliance obligations. Yes, this costs valuable capital in the form of technology builds and legal costs even in the presence of incomplete information from the regulator.

Question 3a. What kind of internal processes would you like the CFTC to develop to improve their function as a major market regulator?

Answer. FIA supports the legislation passed by the House last year to ensure that the cost-benefit analysis conducted by the CFTC closely follows President Obama's Executive Order for the entire Executive Branch. Requiring more quantitative cost-benefit analysis would seek to identify many of the cost-prohibitive regulatory challenges, or at least reveal such, long prior to the finalization of regulations.

Response from Shawn Bernardo, Chief Executive Officer, tpSEF, Inc. at Tullett Prebon; on behalf of Wholesale Market Brokers Association, Americas

Questions Submitted by Hon. Austin Scott, a Representative in Congress from Georgia

May 26, 2015

Hon. AUSTIN SCOTT,
Chairman,
Subcommittee on Commodity Exchanges, Energy, and Credit,

House Committee on Agriculture,
Washington, D.C.

Re: *Public Hearing on "Reauthorizing the CFTC: Market Participant View" (Mar. 25, 2015)*

Dear Chairman Scott, Ranking Member David Scott, and Members of the Subcommittee on Commodity Exchange, Energy, and Credit:

On behalf of the Wholesale Markets Brokers' Association, Americas ("WMBAA" or "Association"),[1] thank you for the opportunity to testify before the Subcommittee on March 25, 2015 regarding the swap execution facility ("SEF") perspective on the implementation progress of reforms under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

We are pleased to provide responses to the questions submitted by Chairman Scott following the conclusion of the hearing in the attached *Appendix.* Please feel free to contact me with any questions you may have on the WMBAA's responses.

Sincerely,
SHAWN BERNARDO,
Chief Executive Officer, tpSEF, and *Board Member,* WMBAA.

APPENDIX

Question 1. Mr. Bernardo, why are CFTC's interpretive guidance and no-action relief letters "difficult to comply with and lack the permanence needed to build systems and platforms to their requirements?" How have these staff decisions made the SEF registration process more difficult?

Answer. While the WMBAA appreciates the hard work and dedication of the staff of the Commodity Futures Trading Commission ("CFTC" or "Commission"), the WMBAA is concerned that the Commission's numerous staff no-action letters and guidance releases have been unproductive from market participants' compliance and business planning perspectives. In order to confidently build business processes and infrastructure to implement SEF related requirements and ultimately receive permanent registration, SEFs require clear and consistent regulatory requirements. There have been multiple instances, however, in which staff no-action letters and guidance have altered the impact of a regulatory requirement and increased uncertainty among market participants.

The multiple staff no-action relief letters pertaining to single issues highlight the shifting nature of the Commission's approach to implementation issues. As noted, SEFs require regulatory certainty to confidently invest resources to build the appropriate systems and platforms required for permanent registration. The following examples involving multiple no-action relief letters, for example, while arguably necessary for immediate relief, lack permanence and do not provide market participants with regulatory certainty.

SEF Confirmations and Footnote 195

For example, staff has issued two no-action relief letters related to CFTC rule 37.6, which requires in part that a SEF "provide each counterparty to a transaction that is entered into on or pursuant to the rules of the [SEF] with a written record of all of the terms of the transaction which shall legally supersede any previous agreement and serve as a confirmation of the transaction." In the associated preamble discussion pertaining to this requirement, the Commission stated that SEFs could satisfy such requirement by incorporating by reference terms in previously negotiated agreements by the counterparties, *provided* that such agreements had been submitted to the SEF before execution.

This requirement and associated preamble discussion were problematic for market participants from a compliance perspective for various reasons. In response to market participant concerns, the Commission's Division of Market Oversight ("DMO") issued a no-action relief letter in August 2014, which contained conditions that

[1] The WMBAA is an independent industry body representing the largest inter-dealer brokers operating in the North American wholesale markets across a broad range of financial products. The five founding members of the group are: BGC Partners; GFI Group; ICAP; Tradition; and Tullett Prebon. The WMBAA membership collectively employs approximately 4,000 people in the United States; not only in New York City, but in Stamford, Connecticut; Chicago, Illinois; Louisville, Kentucky; Jersey City, New Jersey; Raleigh, North Carolina; and Houston and Sugar Land, Texas. For more information, please see *www.wmbaa.org.*

caused the letter to fall short of providing meaningful relief to SEFs.[2] Most recently, in April 2015, in response to renewed market participant calls for Commission resolution of this issue, DMO released a second no-action relief letter regarding this requirement, among others, providing relief until March 2016.[3]

While the WMBAA appreciates staff's continued engagement with market participants on this issue, this particular requirement based in the preamble discussion is impracticable, overly burdensome, very costly to implement, and does not appear to provide meaningful public policy benefits to regulators or the public. Accordingly, the WMBAA believes that permanent relief is needed through a formal rule change, rather than temporary relief through a time-limited no-action letter.

Operational or Clerical Error Trades

CFTC staff's response to "error trades" in the form of no-action relief letters has injected unnecessary regulatory complexity into the trade execution process.

In September 2013, the CFTC staff issued joint guidance regarding obligations related to "the clearing of swaps that are traded on or through the facilities of SEFs or [designated contract markets ('DCMs')] and cleared at [derivatives clearing organizations ('DCOs') by [futures commission merchants ('FCMs')] that are clearing members of the DCO" ("STP Guidance").[4] Among other aspects of the clearing process, staff discussed the "effect of rejection from clearing," stating that "any trade that is executed on a SEF or DCM and that is not accepted for clearing should be void *ab initio*."[5]

Market participants expressed concern, however, that trades would be rejected by DCOs for flaws that are readily correctable, *e.g.*, due to an operational or clerical error. In response to such concerns, CFTC staff issued no-action letters in October 2013 and in April 2015, which allow a SEF to permit a new trade, with terms and conditions that match the terms and conditions of the original trade, other than any error of the original trade and the time of execution, to be submitted for clearing.[6] The no-action relief effectively permits SEFs "to implement rules that establish a 'new trade, old terms' procedure."[7]

Rather than permit the "new trade, old terms" procedure, the WMBAA believes that the Commission has an opportunity to simplify the error trade correction process by permitting SEFs to send a correction message for a transaction that has been cleared by a DCO. As noted by CFTC staff, "if an error is identified after a swap has cleared, any correction or cancellation necessarily would have to be undertaken by the DCO because only the DCO is able to make corrections or cancellations to swaps carried on its books."[8] Some DCOs, however, currently "decline or are unable to correct or cancel the swaps carried on their books."[9]

While the "new trade, old terms" procedure may be necessary for immediate relief in handling error trades, this process should serve only as an interim solution. Before the expiration of the most recent no-action relief, the Commission should work with DCOs to devise a less complex process, whereby SEFs can send a correction to a trade cleared by a DCO rather than execute a new trade.

Package Transactions

As described by the Commission, a package transaction "is a transaction involving two or more instruments: (1) that is executed between two or more counterparties; (2) that is priced or quoted as one economic transaction with simultaneous or near simultaneous execution of all components; (3) that has at least one component that is a swap that is made available to trade and therefore is subject to the CEA section 2(h)(8) trade execution requirement; and (4) where the execution of each component is contingent upon the execution of all other components."[10]

In response to market participant concerns that the application of the trade execution requirement to package transactions would present challenges for FCMs and DCOs in processing such transactions, as well as for SEFs and DCMs in facilitating trade execution for such transactions, CFTC staff issued no-action letters to provide a phased compliance timeline for entities and counterparties with respect to package

[2] CFTC Letter No. 14–108 (Aug. 18, 2014), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-108.pdf*.

[3] CFTC Letter No. 15–25 (Apr. 22, 2015), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/15-25.pdf*.

[4] Staff Guidance on Swaps Straight-Through Processing, Sept. 26, 2013, available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/stpguidance.pdf*.

[5] *Id.* at 5.

[6] *See* CFTC Letter no. 13–66 (Oct. 25, 2013); CFTC Letter no. 15–24 (Apr. 22, 2015).

[7] *See* CFTC Letter no. 13–66 at 3.

[8] CFTC Letter no. 15–24.

[9] *Id.*

[10] CFTC Letter no. 14–62 (May 1, 2014).

transactions. Confusion remains, however, regarding how to execute those products that may be included in a package transaction, yet are not under the CFTC's regulatory jurisdiction, *e.g.,* Treasury spreads.[11]

Without additional clarity from the Commission regarding the execution of such transactions, SEFs and other market participants are unable to confidently invest in resources to develop implementation solutions for package transactions. This will have serious negative consequences for market participants, including asset managers and end-users, as has been noted by other swap market participants.[12]

Question 2. Mr. Bernardo, can you explain how the Commission's proposed position limits and aggregation rules would impact SEFs? From your perspectives, is it possible to comply with them as they have been proposed?

Answer. Under the Commission's proposed position limits rules, SEFs would be required to adhere to various requirements in setting position limits for both contracts that are subject to the Federal position limits and contracts that are not subject to Federal position limits.

In terms of statutory provisions for SEFs related to position limits, the Dodd-Frank Act established core principles for SEFs, including Core Principle 6 regarding position limits or accountability, which requires SEFs to set position limits or accountability levels, "as is necessary and appropriate," for participants and customers of their facilities. In addition, the core principle requires that the SEF: (1) establish a position limit no higher than a CFTC position limitation; and (2) monitor positions established on or through the SEF for compliance with the limit set by the Commission and the limit, if any, set by the SEF.

As a preliminary matter, SEFs are ill-equipped to establish position limits for swaps, as they do not have access to the necessary market-wide information.[13] Further, the WMBAA does not believe that a SEF should be required to monitor and enforce position limits or accountability levels due to the inherent limits to a SEF's ability to monitor participant positions. Position limits or accountability levels apply market-wide to an entity's overall position in a given swap, commodity, or instrument subject to limits and ownership and control provisions. To monitor an entity's positions and take action to enforce such a market-wide requirement, a SEF would need to have access to information about an entity's overall positions in the swap and underlying instrument or commodity, which it does not have.

A SEF does not have access to such information because a SEF does not own the swap contracts traded on its facility. Rather, swaps can be traded on various facilities and the contracts are fungible. In other words, a swap that is listed on one SEF can be, and currently is, listed and traded on other SEFs and designated contract markets ("DCMs"). Such swaps may also be, and currently are, traded bilaterally off-facility between counterparties away from any SEF or DCM. As a result, SEFs and DCMs listing swaps do not possess complete information about a trader's position in any given swap. Instead, a SEF only has information about swap transactions that take place on its execution venue and has no knowledge of whether a particular trade on its facility adds to an existing position or whether it offsets all or part of an existing position in that swap.

In terms of a SEF position accountability regime, the WMBAA believes that position accountability is meaningful as a market surveillance tool only in the context of centralized marketplaces such as exchanges, due to the fact that they own the products traded and possess information about traders' actual positions in the relevant derivatives marketplace. Because SEFs do not own products, and therefore do not possess the same position information, it would not be appropriate for SEFs to adopt position accountability. While there have been suggestions that SEFs adopt, in effect, "trading accountability" provisions as a means of complying with Core Principle 6 (*i.e.,* SEFs would institute enhanced oversight of and data gathering from a trader based solely on trading activity or the size of transactions), this would be problematic for two reasons. First, the Commodity Exchange Act, as amended by the Dodd-Frank Act, does not contemplate a trading activity-based accountability regime, but rather contemplates a position management-focused component. Further-

[11] For example, market participants' confusion regarding Treasury spreads is amplified by potential Commission action to require post-trade anonymity, as a counterparty requires knowledge of the other counterparty to exchange the Treasury spread.

[12] *See* Securities Industry and Financial Markets Association, Asset Management Group, letter to CFTC (May 11, 2015), available at *http://www.sifma.org/issues/item.aspx?id=8589954630*.

[13] Position limit information is collected by market participants, DCOs, and swap data repositories ("SDRs"). However, even a DCO or SDR would only have information about traders' cleared positions or reported positions at its individual organization. Only the participants themselves would have information about their overall cleared and uncleared swaps position in a market.

more, there is no clear metric available for SEFs to conduct a position accountability framework.

In contrast, the WMBAA believes that the CFTC—or a market—encompassing self-regulatory organization ("SRO") such as the NFA that has been deputized by the CFTC—would have access to complete information about an entity's positions; be able to effectively analyze and police the swap market to detect position limit and accountability level breaches; and institute meaningful enforcement actions to address violations.

The WMBAA recently delivered a White Paper to the CFTC on this topic. We look forward to further engagement with the agency on this issue.

Question 3. Mr. Bernardo, you testified that certain CFTC's swaps "requirements have proven to be impracticable to implement or detrimental to market liquidity." What requirements are causing problems and how are the impacts to the markets you operate in?

Answer. In addition to the aforementioned implementation issues noted in response to *Questions 1* and *2,* the WMBAA offers the following additional examples of CFTC requirements that have been problematic for market liquidity.

Embargo Rule

According to CFTC rule 43.3, a SEF is prohibited from disclosing swap transaction and pricing data related to public reportable swaps before public dissemination of such swap data by a swap data repository ("SDR") unless certain conditions are met, including that "such disclosure is made no earlier than the transmittal of such data to a registered [SDR] for public dissemination."

As a result of the embargo rule, however, SEFs and DCMs that would like to continue to permit work-ups may face workflow issues because they cannot share trade information with their customers until such information is transmitted to an SDR. Due to the discontinuous nature of derivatives transactions, the work-up process is a vital price discovery mechanism. Under this model, once a price is agreed for trading, the resulting trade is reported to market participants, who are offered the opportunity to "join the trade" and trade additional volume at the recently-established market price, which in turn increases liquidity. Work-up enables traders to assess the markets in real-time and make real-time decisions on trading activity and, without such a mechanism, fewer transactions would likely be executed on facility. In addition, those SEFs that rely on a third party to transmit information to SDRs are further hindered by the embargo rule in their ability to make available to all market participants current market information. Such delays can have a material effect on market liquidity and are detrimental to a SEF's ability to provide liquidity on a real-time basis to its participants.

The embargo rule is also disruptive to the functioning of electronic markets. To operate efficiently and competitively, information which reflects current market activity must be available to all market participants without any disruptive pauses for the occurrence of other regulatory activities. Every market participant must have real-time information on executed trades for the entire marketplace to ensure effective price discovery so that they can make informed trading decisions. This allows the venue to operate properly as a single liquidity pool.

Cross-Border Concerns

In November 2013, the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") issued staff advisory 13–69, which responded to certain inquiries from swap market participants regarding the applicability of the Commission's Transaction-Level Requirements in the cross-border context.[14] Transaction-Level Requirements include, among other rules, mandatory trade execution, requiring that a swap be executed on a DCM or SEF.

To the surprise of market participants, the guidance stated that "a non-U.S. [swap dealer ('SD')] (whether an affiliate or not of a U.S. person) regularly using personnel or agents located in the U.S. to arrange, negotiate, or execute a swap with a non-U.S. person generally would be required to comply with the Transaction-Level Requirements." It further stated that this approach would apply to "a swap between a non-U.S. SD and a non-U.S. person booked in a non-U.S. branch of the non-U.S. SD if the non-U.S. SD is using personnel or agents located in the U.S. to arrange, negotiate, or execute such swap."

Following the release of staff advisory 13–69, Commission staff received from non-U.S. SDs requests for time-limited relief from compliance with the Transaction-Level Requirements when engaging in swaps with non-U.S. persons using personnel

[14] CFTC Staff Advisory No. 13–69 (Nov. 14, 2013), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-69.pdf.*

or agents located in the United States to arrange, negotiate, or execute such swaps. In response, the Commission issued and extended time-limited no-action relief on four separate occasions, including most recently through no-action letter 14–140 in November 2014.[15] In addition, in January 2014, the Commission issued a request for public comment on staff advisory 13–69.[16]

The WMBAA believes that the scope of the Commission's cross-border approach in staff advisory 13–69 is far reaching, as it may subject to SEF execution even a permitted transaction involving two non-U.S. counterparties. Currently, there is a lack of clarity regarding who is a U.S. person for mandatory trade execution purposes and, relatedly, what types of transactions may be conducted away from a SEF.

In addition, this staff guidance has bifurcated markets based on a market participant's jurisdiction, which in turn has impeded liquidity and redirected trading activity away from SEFs. In effect, U.S. persons are being limited to less liquid venues for their trade executions, as non-U.S. persons have displayed a strong preference for trading on facilities other than SEFs, particularly with respect to non-U.S. dollar markets. The WMBAA believes that the impact of this staff guidance runs counter to the transparency goals underlying Dodd-Frank, as it is currently causing more trading to occur away from the U.S. markets and the oversight of U.S. regulators.

[15] CFTC Letter No. 14–140 (Nov. 14, 2014), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-140.pdf*.

[16] *Request for Comment on Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of the Non-U.S. Swap Dealers Located in the United States,* 79 FED. REG. 1,347 (Jan. 8, 2014).

REAUTHORIZING THE COMMODITY FUTURES TRADING COMMISSION (COMMISSIONERS' PERSPECTIVES)

TUESDAY, APRIL 14, 2015

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY, AND CREDIT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 1300 of the Longworth House Office Building, Hon. Austin Scott of Georgia [Chairman of the Subcommittee] presiding.

Members present: Representatives Austin Scott of Georgia, Lucas, LaMalfa, Davis, Emmer, Conaway (*ex officio*), David Scott of Georgia, Vela, Maloney, Kirkpatrick, and Aguilar.

Staff present: Caleb Crosswhite, Haley Graves, Jackie Barber, Jessica Carter, Mollie Wilken, Paul Balzano, Scott Graves, Ted Monoson, Kevin Webb, John Konya, Liz Friedlander, Matthew MacKenzie, and Nicole Scott.

OPENING STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

The CHAIRMAN. Well, good morning. We had to wait on the hammer. Good morning, this hearing of the Subcommittee on Commodity Exchanges, Energy, and Credit, regarding the reauthorization of the CFTC as it relates to perspectives of the Commissioners, will come to order.

Good morning, and thank you for joining us for this hearing of the Commodity Exchanges, Energy, and Credit Subcommittee as we continue the Agriculture Committee's work toward CFTC reauthorization.

Thus far, we have appreciated the opportunity to hear perspectives on reauthorization from end-users and market participants. Their testimony has been vital to helping us gain a better and more complete understanding of ways in which our regulatory structure could better serve the markets that it is designed to regulate. Today we will continue our examination of the reauthorization of the CFTC with the important step of hearing from the Commission itself.

I am glad to welcome Commissioner Mark Wetjen, Commissioner Sharon Bowen, and Commissioner Chris Giancarlo to the Committee. This marks the first appearance before Members of this Committee for Commissioner Bowen, so we extend a warm wel-

come to her. And we thank each of you for taking time to appear before us today and share your perspectives on the Commission, what works and, perhaps, what doesn't work.

Guided by our principles that regulatory requirements be both minimized and justified, and that regulations provide clarity and certainty, we hope this reauthorization process will illuminate areas in which we can help the Commission function more efficiently.

Collectively, the Commissioners represent a wide breadth and depth of experience and insight, and we appreciate their willingness to use their talents in service to the public. Accordingly, one of our goals in this Committee is to ensure that each Commissioner at the CFTC is adequately empowered within his or her role.

It has been noted many times before this Committee, but always bears repeating, that derivatives markets are essential not only to the farmers, ranchers, and end-users who utilize them, but to our broader economy. We will continue to look for a healthy balance between market access and market integrity, so that the markets meet the needs of those who use them to hedge.

Thank you again to our witnesses for joining us here today, and thank you for the important work you do at the Commission. You serve our nation well, and we appreciate your choice to do so.

[The prepared statement of Mr. Austin Scott of Georgia follows:]

PREPARED STATEMENT OF HON. AUSTIN SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Good morning. Thank you for joining us today for this hearing of the Commodity Exchanges, Energy, and Credit Subcommittee as we continue the Agriculture Committee's work toward CFTC reauthorization.

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Thank you again to our witnesses for joining us here today, and thank you for the important work you do at the Commission. You serve our nation well, and we appreciate your choice to do so.

With that, I'll turn to our Ranking Member, Mr. Scott.

The CHAIRMAN. With that, I will turn to Ranking Member Scott.

OPENING STATEMENT OF HON. DAVID SCOTT, A REPRESENTATIVE IN CONGRESS FROM GEORGIA

Mr. DAVID SCOTT of Georgia. Thank you very much, Mr. Chairman. And to our distinguished Commissioners, welcome.

As the Democratic Ranking Member, I want to emphasize how pleased I am with the work that we have been able to accomplish so far as we examine the critical issues that affect our markets and our ability to continue in a very good bipartisan process of reauthorizing the Commodity Exchange Act, commonly referred to as the CEA.

So far, we have had several robust Committee hearings in which we have examined the concerns of both our market participants, and we have heard the concerns of our end-users. So, Mr. Chairman, I am pleased with the level of discussion and knowledge that we have had so far in our hearings, and I am delighted today that we will hear from those who handle the infrastructure, those who have to deal with making sure we have a level playing field for both our end-users and our market participants, and protect the best interests of the American people and our fine, outstanding financial system.

Commissioner Wetjen, Commissioner Bowen, and Commissioner Giancarlo, I want to thank you for being here today. You have great perspective. We value your input, we value your views, and we know that you will provide a critical foundation for the work that this Committee must undertake in the reauthorization of the Commodity Exchange Act, but not only that, we really, really respect your involvement and understanding of the deep complexity of this entire issue as we move forward, for it is both your charge and this Committee's charge to have the jurisdiction of the complete Section VII of Dodd-Frank.

Mr. Chairman, I would like to again commend the Committee's previous work where we worked last year on H.R. 4413, which will provide the basis for what we do today. And I am looking forward to hearing from our distinguished panel regarding their thoughts on that particular bill as a framework for us, going forward, but also on some very critical issues like the EU recognition of U.S. clearinghouses, and *vice-versa,* the recognition by the U.S. of foreign clearinghouses. The U.S. definition of *U.S. person,* position limits, cross-border, so many issues that are ratcheting up for us. And as we all know, I have mentioned in every hearing regarding the CEA reauthorization, the importance of providing the CFTC with the adequate level of funding that we need because all of what we deal with, all of what I have just said, means almost virtually nothing if you do not have the funds with which to do the job. And I have continually stressed as we have evolved in this issue of derivatives and swaps, I mean the mission, the clarity and purpose of the CFTC and your workload has increased 400 percent. So I am anxious to hear from each of you that fact, that you do have enough funding, you need more funding, only you are in the best position to tell us the answers to those critical questions on funding.

So finally, let us not forget what the CFTC's primary mission is. It is to foster open, transparent, competitive and financially sound markets, and avoid systemic risk, and protect the market users and

their funds, consumers and the public from fraud or manipulation. What a task. We are looking forward to hearing from you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Scott.

And I see that the full Committee Chairman has joined us, Mr. Conaway from Texas. I would like to recognize you if you have any opening statement.

OPENING STATEMENT OF HON. K. MICHAEL CONAWAY, A REPRESENTATIVE IN CONGRESS FROM TEXAS

Mr. CONAWAY. Well, I don't, other than to say I thank you and David for holding the hearing, and also thank you to our witnesses. You are going to be an integral and important part of the reauthorization process, and so your comments today will be taken very seriously as we move forward on the full reauthorization.

I look forward to the hearing, and I yield back.

The CHAIRMAN. The chair would request that other Members submit their opening statements for the record so that witnesses may begin their testimony, and to ensure that there is ample time for questions.

[The prepared statement of Mr. Goodlatte follows:]

PREPARED STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM VIRGINIA

The Commodity Futures Trading Commission's (CFTC) mission is to foster open transparent, competitive and financially sound markets; avoid systemic risk; and to protect the market users and their funds, consumers and the public from fraud, manipulation and abusive practices.

Toward that end, I appreciate the opportunity for the Subcommittee on Commodity Exchanges, Energy, and Credit to hear from the CFTC Commissioners testifying before us as these markets impact the daily lives of most Americans and the products they consume. In the words of CFTC Chairman Massad, "*we must create a regulatory framework that promotes efficiency and competition, while preventing manipulation and fraud, to ensure that markets continue to able a strong, dynamic engine for economic growth.*"

As you are aware, the CFTC was last reauthorized under the Food, Conservation, and Energy Act of 2008, the 2008 Farm Bill, for a period of 5 years and its authority expired on September 30, 2013. The *Customer Protection and End User Relief Act* approved in the 113th Congress was aimed at ensuring that the Federal agency tasked with regulating the multi-trillion dollar market is working in the most efficient and effective way, as well as bringing into play key protections for futures customers while mitigating the regulatory load on America's job creators.

In an effort to help the CFTC achieve its mission, I have been actively engaged with the Commission regarding their authority to regulate and investigate concerns about the aluminum supply, and potential manipulation of pricing. Toward that end, I appreciate the recent efforts of the CFTC to respond to these critical matters.

Aluminum users from across the county have voiced their strong concerns in recent years as the restrictive flow of aluminim metal out of London Metal Exchange (LME) warehouses has completely distorted the free market system. Users are seeking regulatory and legislative oversight of the LME to ensure a transparent, balanced, and functional market for buyers and sellers.

Last year, I worked with then-Chairman Lucas to incorporate into CFTC reauthorization language requesting a Commission report to Congress on actions undertaken to address concerns relating to aluminum pricing and manipulation. I remain extremely concerned about manufacturers being able to take timely delivery of aluminum for production at a fair price for uses such as common drink cans, which many American's utilize on a daily basis, as well airplane parts, and for other purposes.

Regulatory clarity is needed regarding the jurisdictional roles of the CFTC and the London Metal Exchange. The aluminum warehouses in question are regulated through the LME and are certified in the United States. The LME is said to have

regulations in place, but contend they do not have full authority regarding warehouses located in the U.S. In the past, the CFTC has acknowledged that they have some authority to regulate and investigate concerns about the aluminum supply. In addition, the CFTC has authority over unfair trading and price manipulation, and as such has an obligation of oversight or should advise Congress of the tools needed to carry out this mission. Even the *Senate Select Permanent Subcommittee on Investigations* issued a bipartisan report last year that raised significant concerns regarding aluminum market practices.

I am encouraged by the CTFC's recent attention to this vital issue as Chairman Massad testified on February 12, "*another issue of concern to end-users that we are focused on pertains to the long queues for delivery of aluminum at warehouses in this country licensed by the London Metal Exchange (LME), the relationship of those queues to the pricing and delivery of aluminum, and how these issues impact market integrity and market participants.*"

Furthermore, the Commission's letter to the London Metal Exchange (LME) of March 24 is to be commended, in which the Division of Market Oversight notified the LME that it is exercising its authority under Section 4(b)(1) of the Commodity Exchange Act regarding the LME's application for registration as a foreign board of trade. The CFTC formally deferred review to permit the continued review of LME's activities as it addresses issues surrounding LME-licensed aluminum warehouses that have caused concerns in the market, particularly with respect to pricing in the U.S for aluminum, due or related to the length of warehouse queues.

The CFTC noted, that while LME has made progress in reducing queues, "the results attained to date indicate that more progress is needed" and staff will continue to review LME's actions and well as the implementation of alternatives to reduce the queues at LME licensed aluminum warehouses.

Again these efforts are steps in the right direction and I look forward to working with this Subcommittee, as well as the CFTC, to ensure a regulatory framework that promotes efficiency and competition, while guarding against manipulation and fraud, to be sure markets continue to promote economic growth for their users.

The chair would also like to remind Members that they will be recognized for questioning in order of seniority for Members who were present at the start of the hearing, after that, Members will be recognized in order of their arrival. I appreciate Member's understanding.

Witnesses are also reminded to limit their oral presentation to 5 minutes. All written statements will be included in the record.

I would like to welcome our witnesses to the table. The Honorable Sharon Bowen, Commissioner, Commodity Futures Trading Commission, Washington, D.C.; the Honorable Chris Giancarlo, Commissioner, Commodity Futures Trading Commission, Washington, D.C.; and the Honorable Mark Wetjen, Commissioner, Commodity Futures Trading Commission, Washington, D.C.

Commissioner Bowen, please begin when you are ready.

STATEMENT OF HON. SHARON Y. BOWEN, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Ms. BOWEN. Good morning. Chairman Scott, Ranking Member Scott, Chairman Conaway, Ranking Member Peterson, and Members of the Subcommittee, thank you for inviting me to testify this morning on the reauthorization of the Commodity Futures Trading Commission, on which I serve as a Commissioner. It is an honor and a privilege to appear before you today.

First, I would like to express my gratitude to our extremely hardworking staff. If Members of this Subcommittee leave this hearing with only two new pieces of information today, I hope that it is first, our staff truly are the hardest working, most professional staff in a government agency. Second, that while our staff can accomplish a great deal with limited resources, the agency des-

perately needs additional funding and staff to carry out our mission of regulating and protecting the swaps and futures markets.

If there was some way in this reauthorization to allow the CFTC to set fees on registrants or a *de minimis* fee on trades, as the SEC is empowered to do so, that would be extremely helpful.

I would like to extend my appreciation and thanks to my two fellow Commissioners, Mark Wetjen and Chris Giancarlo, testifying with me today. I am fortunate to serve with them and Chairman Massad. I want to extend my gratitude to our Chairman for addressing a number of concerns of end-users and other stakeholders.

While some of us may disagree about the status of systemic risk to the swaps and futures market, or the wisdom of a particular Dodd-Frank requirement, I hope we can all agree on this: the Commodity Futures Trading Commission should be reauthorized. Its role in overseeing the derivatives market is critical to protecting global financial stability and the U.S. economy, and thus, assuring the American people that their voices and interests are heard.

To that end, I would like to offer a few recommendations to you as you begin this effort to reauthorize this agency. The first, of course, is self-funding, which I mentioned previously. The CFTC was last reauthorized by Congress in August 2008, and as we all know only too well, the world had changed greatly since then.

Second, I believe it is time to reevaluate how our system of self-regulatory organizations is functioning. It will be wise to take a comprehensive look at this system, and to ensure that it is set up to work efficiently, cohesively, and effectively. If a part of it isn't working, or if there is an area of regulation that needs to be addressed, I hope we will do that. In particular, I believe it is prudent to establish a separate SRO just for swaps and market participants. In his recent white paper, Commissioner Giancarlo proposed an established system of professional standards for the swaps market. I think that is a good proposal, and a new SRO for the swaps market will be well positioned to implement this. Establishing standards of eligibility and accountability will enhance and strengthen investor protections.

Third, I believe it would be wise for us to have stricter regulations on the retail foreign exchange swaps industry. As I have previously said, it is ironic that following the enactment of Dodd-Frank, the retail foreign exchange industry is the least regulated part of the derivatives market. I continue to hold this view. In fact, I believe we should make retail foreign exchange swaps, which directly involve retail investors, at least as regulated as the rest of the swap markets. I also continue to believe that the Commission can and should take action on this subject.

Fourth, I believe we should issue new regulations on cybersecurity, but I hope the Commission acts on this on our own very soon. As I recently said in a speech before many operational risk professionals, the fact that trading is now effectively entirely electronic brings with it the risk of cyberattack. As a result, financial actors have become storehouses of massive amounts of data, much of it incredibly sensitive. We have to have protections in place, not only against thieves trying to steal data, but also entities that may be trying to hack into our system just to try and disrupt our financial markets and damage our economy.

Finally, we should increase our enforcement penalties. Put simply, some of our current enforcement penalties really require updating. They should not convey the message that it is just the cost of doing business to pay these penalties. I would support updating these enforcement penalties so they are tough, fair, and fit the scope and scale of the markets we regulate.

Our financial markets are the lifeblood of our economy. They allow capital to be more efficiently invested, and help to allow newer, leaner, and more innovative enterprises and investors to thrive. But without fair, rigorous rules in place, the system breaks down, harming investors, businesses and our overall economy. The CFTC has changed greatly in the last few years, and it is in the best interest of the industry, investors, and the public that the Commission's authorizing legislation is up-to-date so that the CFTC can meet today's challenges, and those that are likely to unfold in the future.

Thank you, and I look forward to your questions.

[The prepared statement of Ms. Bowen follows:]

PREPARED STATEMENT OF HON. SHARON Y. BOWEN, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Chairman Scott, Ranking Member Scott, Chairman Conaway, Ranking Member Peterson, and Members of the Subcommittee, thank you for inviting me to testify this morning on the reauthorization of the Commodity Futures Trading Commission, on which I serve as a Commissioner. It is an honor and a privilege to appear before you today.

First, I would like to express my gratitude to our extremely hard-working staff. Despite suffering from significant funding and resource constraints and the massive new mission of regulating and policing the swaps market, their performance has been exemplary. I remain impressed with their invaluable expertise and professional commitment to fulfilling our vastly increased Congressional mandate. At present, the CFTC has completed a greater percentage of its Dodd-Frank rules than other domestic financial regulatory agencies. That record of accomplishment is entirely thanks to our staff, who have shared their perspectives and insights with me in these last 10 months. If Members leave this hearing with only two new pieces of information today, I hope it is that first, our staff truly are the hardest-working, most professional staff in a government agency. Second, that while our staff can accomplish a great deal with limited resources, the agency desperately needs additional funding and staff to carry out our mission of regulating and protecting the swaps and futures markets.

I would also like to extend my appreciation and thanks to my two fellow Commissioners testifying with me here today. Commissioner Giancarlo brings with him a wealth of private sector experience in the swaps industry and he makes use of it in every open meeting, every roundtable, and every discussion we have. Commissioner Giancarlo and I experienced the confirmation process together; sometimes, we would even have joint meetings with individual Senators, and that gave us a bond that I believe has made it easier for us to reach consensus on some of our mandates. Commissioner Wetjen, who now has the longest tenure of the four of us, has been an invaluable source of expertise and insight to the rest of us. He has been able to inform us of why certain actions were taken prior to our arrival. But beyond merely being a repository of institutional memory, he also deserves immense praise for serving as Acting Chairman for approximately 6 months last year and for his many piercing questions and insights about potential risks and impacts of a proposed CFTC action. I am fortunate to serve with my fellow Commissioners.

I also want to extend my gratitude to our Chairman, Tim Massad, who has worked hard to address a number of concerns of end-users and other stakeholders. He brings an incredibly detail-oriented viewpoint, a steel-trap memory of the evolution of the markets we regulate, and a formidable intellect. I've seen Chairman Massad tell our staff that the CFTC should be the most interesting, professional, and all-around best financial regulator in the government and I know that's a goal he strives to fulfill. It is a goal I share and I am glad we can work together to make it a reality.

My experience and what I bring to the table is broad both professionally and personally. I have a 32 year career as a lawyer on Wall Street and a 58 year career as a consumer and investor. I am also someone who personally witnessed families and friends lose their jobs, homes, and retirement accounts during the financial crisis. Frankly, they believed that they would be okay because they worked hard, had the right education, and made personal sacrifices.

While some of us may disagree about the state of systemic risks to the swaps and futures markets or the wisdom of particular Dodd-Frank requirements, I hope we can all agree on this: the Commodity Futures Trading Commission should be reauthorized. Its role in overseeing the derivatives market is critical to protecting global financial stability and the U.S. economy and thus assuring the American people that their voices and interests are being heard.

The CFTC was last reauthorized by Congress in August 2008, and as we all know only too well, the world has changed greatly since then. The last reauthorization occurred before Lehman crashed, before the national unemployment rate hit 10%, and before the Dodd-Frank Wall Street Reform Act was enacted into law, giving the CFTC new powers and responsibilities, including jurisdiction over the vast majority of the swaps market.

It is in fact nearly 5 years even since Dodd-Frank. In markets as dynamic as these, where trading practices and strategies are dynamic and can change within quarters, weeks, or even days, 5 years is a lifetime. I have a few recommendations I believe will enhance the ability of the CFTC to protect markets, investors, and consumers.

First, and most importantly, there is the issue of resources. Much has been said about the topic of funding of course, but I believe a little more discussion is needed. Frankly, I believe it would be prudent to establish some kind of mechanism that allows the Commission to self-fund. We are grateful for the $35 million increase in appropriations we received in last December's legislation to fund the government, which raised our annual budget from $215 million in Fiscal Year 2014 to $250 million for Fiscal Year 2015. However, that $35 million is a drop in the bucket considering the scope of our mission to regulate the swaps and futures markets. According to the most recent numbers I've seen, the futures market in the United States, which was the primary market we regulated prior to Dodd-Frank, is estimated to be more than $30 trillion total at present.[1] Meanwhile, the U.S. swaps market is estimated to be approximately $400 trillion today.[2] As a point of comparison, the legislation that funded the entire government last December, the so-called "Cromnibus," appropriated just over $1 trillion, and the entire U.S. gross domestic product in 2014 was estimated as just over $17.4 trillion.[3] So, by mandating in Dodd-Frank that we regulate the domestic swaps market, Congress increased our overall jurisdiction by over 1,300%.

While our budget has increased in recent years, it has not kept pace with that massive increase in our mission. In Fiscal Year 2009, the entirety of which was prior to Dodd-Frank's passage but which did cover the heart of the 2008 financial crisis, our budget was $146 million.[4] For Fiscal Year 2015, our budget is $250 million, an increase of $104 million since Fiscal Year 2009.[5] So, we've now got $104

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[1] *See* Bank for International Settlements, "Derivatives Financial Instruments Traded on Organized Exchanges," available at *http://www.bis.org/statistics/r_qa1503_hanx23a.pdf* & *Commodity Futures Trading Commission, FY 2014 Annual Performance Report & FY 2016 Annual Performance Plan, February 2015,* at page 6, available at *http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2014apr.pdf*. Note, figures are in gross notional dollars. Please note that in 2009, the futures market was also smaller, being estimated at approximately $22 trillion. *Commodity Futures Trading Commission, Budget and Performance Estimate for FY 2010,* May 7, 2009, available at *http://www.cftc.gov/reports/presbudget/2010/2010presidentsbudget01.html*.

[2] *Commodity Futures Trading Commission, FY 2014 Annual Performance Report & FY 2014 Annual Performance Plan, April 10, 2013,* at page 6, available at *http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2014apr.pdf*. Note, even if one looks at gross market value instead of gross notional, the global swaps market was still valued at over $17 trillion in mid-2014. *See* Bank for International Settlements, "Amounts of Outstanding Over-the-Counter (OTC) Derivatives," available at *http://www.bis.org/statistics/dt1920a.pdf*.

[3] Federal Reserve Bank of St. Louis, "Gross Domestic Product," available at *http://research.stlouisfed.org/fred2/series/GDPA*. Note—GDP as valued in chained 2009 dollars is just over $16 trillion. Federal Reserve Bank of St. Louis, "Real Gross Domestic Product," available at *http://research.stlouisfed.org/fred2/series/GDPCA*.

[4] *Commodity Futures Trading Commission, Budget and Performance Estimate for FY 2010,* May 7, 2009, available at *http://www.cftc.gov/reports/presbudget/2010/2010presidentsbudget01.html*.

[5] *Commodity Futures Trading Commission, President's Budget—Fiscal Year 2016,* February 2, 2015, at pages 1 & 7, available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2016.pdf*.

million to regulate an additional $400 trillion of jurisdiction, and $250 million to regulate the combined, greater-than $430 trillion domestic swaps and futures markets. To use the language of finance, the government is currently making an investment that is leveraging $1 of regulatory funding for every $1,720,000 of the swaps and futures markets.

Our staffing levels have failed to keep pace with our duties. In May 2009, we had 500 people employed at the CFTC.[6] In Fiscal Year 2014, we had 647 full time employees, an increase of 29%.[7] Yet, it's worth noting that we actually had fewer staff in Fiscal Year 2014 than we had just 2 years earlier; in Fiscal Year 2012, we had 687 full-time employees.[8] Despite weathering that nearly 6% cut in staffing levels, our staff has continued to complete our major rulemakings, such as the recent re-proposal of the margin rule, and engaged in major successful enforcement actions, such as the more than $6 billion in fees and penalties the Commission collected in actions against various entities for manipulating notable international benchmark rates.[9] The CFTC staff has literally done more with less.

Yet, while we have been able to survive on our current funding levels, our lack of resources has not just been a challenge for us, it has also been an obstacle to industry, including end-users. With a staff that is stretched so extremely thin, reviews of various applications by derivatives clearing organizations and exchanges can take longer, delaying those organizations' efforts to improve and enhance trading for market participants. With a staff that is stretched so extremely thin, examinations of registrants are more infrequent. That slower rate of regulatory examinations will increase the likelihood that errors and problems that develop at a registrant will not be found and corrected quickly, resulting in greater risk for investors and greater compliance costs for the registrants. And with a staff that is stretched so extremely thin, our rulemaking process will move much more slowly. Not only does that invite additional regulatory uncertainty into the markets we regulate, but it also means that we are less able to craft exemptions for end-users or market participants in a timely fashion, even for those entities who have a critical and real need for them.

Our lack of resources is hampering our ability to function, and it is indirectly slowing down the business of trading, including for the purposes of hedging. Last month, I met with a number of industry participants who praised the excellent job the CFTC's staff was doing under the circumstances but also understood that the lack of funding posed risks both to their businesses and our broader financial system. In fact, they asked what they could do to get us additional funding. I urged them, like I urge all persons with similar views, to make those views known.

Obviously, this is not an appropriations bill and the House Agriculture Committee is not empowered to simply grant us additional money. However, if there was some way in this reauthorization to allow the CFTC to set fees on registrants or a *de minimis* fee on some trades, as the SEC is empowered to do, that would be extremely helpful.[10] The industry participants who engage with the CFTC the most are typically entities asking us to revise a regulation or grant some kind of regulatory relief. Allowing the CFTC to fund itself via the collection of extremely small fees from industry would effectively be allowing the industry to pay a *de minimis* amount of money to receive substantially faster service. Such a funding rubric would have the added benefit of no longer asking American taxpayers to directly foot the bill of setting regulations on the swaps and futures markets. I know that bills have been introduced during the last few Congresses that grant us some kind of fee-setting authority, and the Wall Street Accountability Through Sustainable Funding Act introduced by Reps. DeLauro, Welch, and Courtney last Congress is

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[6] *See Commodity Futures Trading Commission, Budget and Performance Estimate for FY 2010,* May 7, 2009, available at *http://www.cftc.gov/reports/presbudget/2010/2010presidentsbudget01.html*.

[7] *Commodity Futures Trading Commission, President's Budget—Fiscal Year 2016,* at page 8, available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2016.pdf*.

[8] C*ommodity Futures Trading Commission, President's Budget and Performance Plan—Fiscal Year 2014,* April 10, 2013, at page 8, available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2014.pdf*.

[9] *Commodity Futures Trading Commission, President's Budget—Fiscal Year 2016,* at page 38, February 2, 2015, available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2016.pdf*.

[10] Securities and Exchange Commission, "Fee Rate Advisory #3 for Fiscal Year 2015," January 15, 2015, available at *http://www.sec.gov/news/pressrelease/2015-8.html#.VQCsQzYpAyE*.

the best one I've seen to date.[11] I should add that there are many ways to structure such a fee, including establishing *de minimis* fees on all trades, fees on certain riskier trades, or annual fees for registrants. While I may prefer one self-funding mechanism over another, I certainly prefer just about any of them over the *status quo*.

Second, I believe it is time to reevaluate how our system of self-regulation is functioning. Currently, our system of self-regulation doesn't reflect the current market realities or some of the core principles of Dodd-Frank. In the futures space, we require exchanges, such as the IntercontinentalExchange (ICE) or the Chicago Mercantile Exchange (CME), to be SROs. Therefore, they must enforce certain minimum reporting and financial requirements on their members.[12] The National Futures Association (NFA), which is the sole registered futures association, is also an SRO, and it can set minimum rules and standards for their members, which include futures commission merchants (FCMs), introducing brokers (IBs),[13] and retail foreign exchange dealers (RFEDs).[14]

This system, which is admittedly complex, was made more complicated in the wake of Dodd-Frank when we added the swaps market to this rubric. Under CFTC rules, each of the more than twenty swap execution facilities in existence today, is an SRO.[15] As a result, the National Futures Association, which has spent the vast majority of its more than 30 year existence focused almost entirely on the futures industry, serves as the SRO for the swaps industry.[16]

It would be wise to take a comprehensive look at this system and ensure that it is set up to work efficiently, cohesively, and effectively. If a part of it is not working or there is an area that is not receiving the appropriate level of regulation, it should be addressed. In particular, I believe it may be prudent to establish a separate SRO just for market participants who engage in swaps activity. After all, while futures and swaps may be similar in many ways, including the fact that market participants are, with a few notable exceptions, rarely retail investors, they remain quite distinct. I believe a number of the Members here today are familiar with Commissioner Giancarlo's white paper on potential improvements that might be made to our swaps rules. One of his suggestions is that we "establish standards that would enhance the knowledge, professionalism and ethics of personnel in the U.S. swaps markets that exercise discretion in facilitating swaps execution, as well as certain supporting compliance and operations personnel."[17] Commissioner Giancarlo proposed to establish these standards, at least in part, via "an examination regime for interdealer brokers and other personnel . . . ."[18] I support this particular proposal of Commissioner Giancarlo's and believe we should consider whether a new SRO for the swaps market would be better positioned to craft and maintain such an examination regime. And I believe it is in the best interests of protecting customers to do so. Establishing standards of eligibility and accountability will enhance and strengthen investor protections.

Third, I believe it would be wise to establish stricter regulations on the retail foreign exchange swaps industry. I have previously said that "[i]t is ironic, that following the enactment of Dodd-Frank, the retail foreign exchange industry is the least regulated part of the derivatives industry."[19] I continue to hold that view.

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[11] Introduced September 16, 2014, available at *https://www.congress.gov/113/bills/hr5490/BILLS-113hr5490ih.pdf*.

[12] 17 CFR § 1.52, available at *http://www.gpo.gov/fdsys/pkg/CFR-2012-title17-vol1/pdf/CFR-2012-title17-vol1-sec1-52.pdf*.

[13] Commodity Futures Trading Commission, "Futures Commission Merchants (FCMs) & Introducing Brokers IBS)," available at *http://www.cftc.gov/IndustryOversight/Intermediaries/FCMs/fcmib*.

[14] National Futures Association, "Retail Foreign Exchange Dealer (RFED)," available at *https://www.nfa.futures.org/nfa-registration/rfed/index.HTML*.

[15] Commodity Futures Trading Commission, "Core Principles and Other Requirements for Swap Execution Facilities," 17 CFR Part 37, June 4, 2013, at page 33521, available at *http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-12242a.pdf*. ("[T]he Commission notes that it views SEFs as SROs, with all the attendant self-regulatory responsibilities to establish and enforce rules necessary to promote market integrity and the protection of market participants." (citation omitted)).

[16] National Futures Association, "NFA's Role in the U.S. Futures Industry," available at *http://www.nfa.futures.org/nfa-about-nfa/who-we-are/NFAs-role-US-futures-industry.HTML*.

[17] Commissioner J. Christopher Giancarlo, Commodity Futures Trading Commission, "Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank," at pages 72–73, January 29, 2015, available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf*.

[18] *Id.* at page 73.

[19] Commissioner Sharon Y. Bowen, Commodity Futures Trading Commission, "Statement of U.S. Commodity Futures Trading Commissioner Sharon Bowen Regarding Recent Activity in the

Yet, I increasingly think my prior statements on this industry understate the risks within the current retail foreign exchange regime. As Bloomberg Markets reported in December 2014, "the two biggest publicly traded over-the-counter forex companies—FXCM Inc. and Gain Capital Holdings, Inc., show that, on average, 68 percent of investors had a net loss from trading in each of the past four quarters." [20] Despite the likelihood that the average investor will lose money, this is an industry where leverage ratios remain at fifty-to-one, meaning that a person with a $500 account is allowed to trade $25,000. In other words, the outsized risks at play in this market can quickly cause an investor to be wiped out. And while this industry may not be as large as the broader dollar currency markets, where trillions of dollars are exchanged every day, the retail foreign exchange market is not small by any stretch of the imagination.[21] One analyst at the Aite Group estimated that twenty million individual investors globally trade $400 billion a day, "some making bets of just a few hundred dollars . . . ." [22]

We do not have to surmise about the possibility of an event occurring in this market that causes risks to individual investors and the broader financial system—we already experienced one. On January 15th, the Swiss National Bank announced that it would no longer cap the exchange rate of the Swiss Franc *versus* the Euro, triggering chaos in the currency markets.[23] In particular, one U.S. dealer of retail foreign exchange, the aforementioned FXCM, nearly went out of business after its customers lost more than $200 million, placing the company on the hook for those losses.[24]

To ward off the risk of such a future event, I would recommend rulemaking requirements to bring the level of regulation on the retail foreign exchange markets at least up to the level of the rest of the swaps market. In fact, I believe retail foreign exchange swaps, which directly (and uniquely for the CFTC) involve retail investors, should be more regulated than the rest of the swaps market. There are a number of regulatory tools that can be utilized, from higher capital standards to best execution requirements, and from segregated customer accounts to stricter margin requirements.

Fourth, I believe it is time for us to issue new regulations on cybersecurity. President Obama eloquently spoke about this topic at our State of the Union as it applies to our economy more broadly and I discussed this topic at a recent conference in New York on operational risk.

As I said then, the fact that so much of trading is now entirely electronic brings with it the risk of cyberattack. As a result, "financial actors have become storehouses for massive amounts of data, much of it incredibly sensitive. From information about trading strategies to clients' social security numbers, the damage that could be done via a major cyberattack on an exchange, clearinghouse, Swap Execution Facility (SEF), or systemically important financial institution is considerable." [25] And the days of cyberattacks being primarily lone wolves interested in making money are gone. We have to have protections in place not only against such thieves but also against entities that may be trying to hack into a system just to try and disrupt our financial markets and thereby damage our economy.

As I said in my conference speech last month, "standardization is not necessarily our friend" with regards to cybersecurity—if there is one single national or industry wide-standard, "that just means we've created a blueprint for all our registrants to be hacked." [26] Thus, it would be prudent to establish cybersecurity regulations on futures and swaps market participants that are more rigorous than regulations on the rest of the private sector and to establish even more rigorous regulations on key market participants, such as extremely large trading entities and exchanges. The regulations on key market participants should not be one-size-fits-all prescriptions,

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Retail Foreign Exchange Markets," January 21, 2015, available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement012115*.

[20] David Evans, "Leverage as High as 50–1 Lures OTC Forex Traders Who Mostly Lose," *Bloomberg.com,* November 12, 2014, available at *http://www.bloomberg.com/news/articles/2014-11-12/leverage-as-high-as-50-1-lures-otc-forex-traders-who-mostly-lose*.

[21] *Id.*

[22] *Id.*

[23] Neil MacLucas & Brian Blackstone, "Swiss Move Roils Global Markets," *Wall Street Journal,* January 15, 2015, available at *http://www.wsj.com/articles/switzerland-scraps-currency-cap-1421320531*.

[24] *Reuters,* "FXCM to Forgive Most Clients' Negative Balances on Swiss Franc Surge," January 28, 2015, available at *http://www.reuters.com/article/2015/01/28/fxcm-forex-idUSL4N0V759V20150128*.

[25] Commissioner Sharon Y. Bowen, Commodity Futures Trading Commission, "Remarks of CFTC Commissioner Sharon Y. Bowen Before the 17th Annual OpRisk North America," March 25, 2015, available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/opabowen-2*.

[26] *Id.*

but instead mostly a series of principles that firms should meet via their own, bespoke cybersecurity protections. In other words, it would be a tiered regime of cybersecurity protections—a baseline level of protections for all futures and swaps market participants and a higher level of additional, specifically tailored protections for the most at-risk firms.

Finally, we should increase our enforcement penalties. Put simply, some of our current enforcement penalties require updating; they should not convey the message that it is just a cost of doing business to pay these penalties. For instance, if an entity engages in market manipulation that is very disruptive to the market but makes very little profit itself (or even loses money in the effort), the damages we could assess civilly could be capped at $1 million.[27] That is a sizable sum, but given the size of these markets and some of the institutions who are registered with us, the cap is too low. Similarly, if a person provides false information to the Commission in a filing, the damages could be capped at just $140,000.[28] I would support updating these enforcement penalties so that they are tough but fair and fit the scope and scale of the markets we regulate.

I am a firm believer in robust enforcement of our rules and laws, but I also believe that we have to take a multi-pronged approach to protecting consumers and investors. Beyond having rigorous enforcement, we also need to be educating consumers about the market and making it possible for them to make smart, safe choices when they choose to invest. To that end, we have established a new national campaign, called CFTC SmartCheck, to provide consumers with tools to check the backgrounds of their financial professionals and thereby protect themselves from financial fraud.[29]

I agree with Chairman Massad that "The United States has the best financial markets in the world. They are the strongest, most dynamic, most innovative, and most competitive—in large part because they have the integrity and transparency that attracts participants. They have been a significant engine of our economic growth and prosperity. The CFTC is committed to doing all we can to strengthen our markets and enhance those qualities."[30]

If anything, I would go a step farther—our financial markets are the lifeblood of our economy. They allow capital to be more efficiently invested and help allow newer, leaner, and more innovative enterprises and investors to thrive. But without fair, rigorous rules in place, the system breaks down, harming investors, businesses, and our overall economy. The CFTC has changed greatly in the last few years and it is in the best interest of the industry, investors, and the public that the Commission's authorizing legislation is up-to-date so that the CFTC can meet today's challenges and those that are bound to unfold in the future. Thank you, and I look forward to your questions.

The CHAIRMAN. Thank you.

Commissioner Giancarlo.

STATEMENT OF HON. J. CHRISTOPHER GIANCARLO, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. GIANCARLO. Good morning, Chairman Scott, Ranking Member Scott, and Chairman Conaway, thank you for the very kind introduction, and thank you for the opportunity to testify.

I want to first thank the CFTC staff for their hard work and dedication, and I also thank my fellow Commissioners. It is a privilege to work with such fine colleagues in service to the American people.

This is my first appearance before you as a Commissioner. Let me briefly say that I have been a consistent advocate for the three pillars of Title VII of Dodd-Frank; enhanced swaps transparency,

[27] 7 U.S.C. § 9(10).
[28] *Id.*
[29] *http://smartcheck.cftc.gov/*.
[30] Chairman Timothy G. Massad, Commodity Futures Trading Commission, "Testimony of Chairman Timothy G. Massad Before the U.S. House Committee on Agriculture," February 12, 2015, at page 25, available at *https://agriculture.house.gov/sites/republicans.agriculture.house.gov/files/images/committee-photo-archives/Testimony%20-%20CFTC%20-%20House%20Ag%20-%20Feb%2012%202015.pdf*.

regulated swaps execution, and increased central counterparty clearing. My support for these reforms is based on over a dozen years as an operator of global marketplaces for swaps trading. I believe that balanced and well-crafted regulatory oversight should go hand in hand with vibrant, transparent, and competitive markets essential to American prosperity.

As you know, the passage of the Dodd-Frank Act was made possible by the promise to exempt commercial end-users, yet over the past few years, end-users have been caught up in the CFTC's rule writing. As I elaborate on in my written testimony, there are several important provisions that the Committee can include in reauthorization to provide relief to the farmers, ranchers, energy companies, utilities, and manufacturers who rely on our derivative markets.

I am pleased that last fall the Commission provided relief to not-for-profit, taxpayer-owned utilities to manage risks in the production of electricity and natural gas. We also provided relief with respect to when residual interest was calculated so as not to overly burden the customers of future commission merchants who use futures to manage their everyday business risk. Yet we must do more. My fellow Commissioners and I are at work on changing burdensome recordkeeping requirements under our rule 1.35, and improving our guidance on when forwards with embedded volumetric optionality are excluded from treatment as swaps. And I am hopeful that we can all agree that trade options should not be subject to position limits.

We have not yet resolved all of these end-user issues, but what is noticeable is that we are working together as a Commission to achieve a better outcome. Still, CFTC rules on position limits remain a work in progress. They were meant to curb excessive speculation that was arguably present in the market when the Dodd-Frank Act was written, yet market conditions today have dramatically changed, especially in U.S. energy markets where speculation appears to show no presence at all in the decline in energy prices.

Unfortunately, the CFTC's rule proposal would impose the most complex and restrictive position limits rule you can imagine. It would reject the successful experience of U.S. futures exchanges in managing position accountability levels. Instead, it would impose one-size-fits-all hard limits, with sharply reduced and narrowed exceptions for *bona fide* hedging. It would substitute Washington regulatory dictates for the commercial judgment of America's farmers, ranchers, and manufacturers when it comes to everyday business risk management. We must be sure that in curbing excessive speculation, we do not place costly burdens on hedgers, end-users, and American consumers; the very ones that Congress intended to protect in the first place.

Earlier this year, I published a white paper analyzing the CFTC's swaps trading rules. I believe that Congress got it right with a straightforward and flexible legislative framework well suited to inherent market dynamics. Unfortunately, the CFTC's rules did not follow Congress' simple outline. These rules have produced enormous regulatory complexity without meaningful market benefit, wasting taxpayer money at a time when the agency is seeking additional funding. Instead, I have proposed a pro-reform swaps

trading regulatory framework built upon five key tenets: comprehensiveness, cohesiveness, flexibility, professionalism, and transparency.

The 2009 Pittsburgh Accords call for global financial reform through coordinated regulatory action, yet for some time, unsatisfactory relations between the CFTC and its overseas counterparty regulators threatened a modern day trade war in financial services. Regulators on both sides of the Atlantic continue to erect separate complex regulatory protocols that struggle to interact with each other, and meanwhile, Asian authorities take a wait-and-see approach. The result is fragmentation of global financial service markets into distinct national and continental sectors. This will slow worldwide economic growth. This will not reduce systemic risk, but increase it. I am pleased to note, however, that Chairman Massad and CFTC staff, especially the Division of Clearing and Risk, are working constructively with our international counterparts.

The CFTC has accomplished much since the passage of the Dodd-Frank Act, yet it must do more to reduce regulatory burdens on end-users. It must also match its oversight of U.S. exchange traded derivatives with excellence and regulating swaps markets, while addressing growing global market fragmentation.

I look forward to working with this Committee and with my CFTC colleagues to complete these important tasks. Thank you.

[The prepared statement of Mr. Giancarlo follows:]

PREPARED STATEMENT OF HON. J. CHRISTOPHER GIANCARLO, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Good morning, Chairman Scott, Ranking Member Scott, and Members of the Subcommittee. Thank you for the opportunity to testify on the reauthorization of the Commodity Futures Trading Commission (CFTC). I am honored to testify alongside my fellow Commissioners Mark Wetjen and Sharon Bowen and provide my perspective on the CFTC's reauthorization.

I want to first thank the CFTC staff for their hard work and dedication. I also want to thank my fellow Commissioners. It is a privilege to work with them in service to the American people. I believe the CFTC has a new spirit of cooperation and professionalism under Chairman Massad, not only internally within the CFTC, but also externally with other regulators and market participants. Before I continue, I make the standard disclaimer that my remarks reflect my own views and do not necessarily constitute the views of the CFTC, my fellow CFTC Commissioners or of the CFTC staff.

As this is my first appearance before you as a Commissioner, let me briefly say by way of professional introduction that I have been a consistent advocate for practical and effective implementation of the three key pillars of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act):[1] enhanced swaps transparency through data reporting, regulated swaps execution and increased central counterparty (CCP) clearing. My support for these reforms is based on over a dozen years' of practical experience as a business professional and operator of global marketplaces for swaps trading. I believe that balanced and well-crafted regulatory oversight goes hand-in-hand with vibrant, transparent and competitive markets, a growing U.S. economy and American job creation.

In my first year on the Commission, I have focused on four major issue sets:

I. Commercial end-user concerns;
II. Derivatives trading position limits;
III. CFTC swaps trading rules; and
IV. Cross-border impact of derivatives regulation.

I am pleased by this opportunity to update you on concerns in each of these areas.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

I. Commercial End-User Concerns

As a supporter of the Dodd-Frank swaps reforms, I am disappointed that traditional commodity and energy markets and the end-users who depend on them for a variety of uses have been saddled with a range of unintended consequences of implementation of several of the Dodd-Frank reforms. Derivatives end-users were not the source of the financial crisis. That is why Congress undertook to exempt end-users from the reach of swaps regulation. It is our job at the CFTC to make sure that our rules do not treat them as though they were the cause of the crisis.

A. Proposed Changes to Rule 1.35

In a number of key areas that I will discuss, CFTC action in the wake of Dodd-Frank in both the futures and swaps markets is overly burdening end-users. For example, in 2012, the CFTC revised rule 1.35.[2] The revised rule requires retention of all oral and written records that lead to the execution of a transaction in a commodity interest and related cash or forward transaction in a form and manner "identifiable and searchable by transaction."[3] This recordkeeping must be done (with certain carve-outs) by intermediaries known as futures commission merchants (FCMs), retail foreign exchange dealers, introducing brokers (IBs) and members of exchanges and platforms, known as designated contract markets (DCMs) and swap execution facilities (SEFs).[4]

The revised rule 1.35 has proved to be unworkable. Its publication was followed by requests for no-action relief and a public roundtable at which entities covered by the rule voiced their inability to tie all communications leading to the execution of a transaction to a particular transaction or transactions. End-user exchange members pointed out that business that was once conducted by telephone had moved to text messaging, so the carve-out in the rule for oral communications gave little relief. They pointed out that it was simply not feasible technologically to keep pre-trade text messages in a form and manner "identifiable and searchable by transaction."

Last fall, I voted against a proposed CFTC rule fix that did not do enough to ease this unnecessary burden on participants in America's futures markets.[5] That proposal was a well-intentioned but insufficient attempt to provide relief from unworkable rule 1.35 requirements. Rather than facilitating the collection of useful records for investigations and enforcement actions, the rule imposes senseless costs that fall especially hard on small FCMs that serve as intermediaries between American farmers and manufacturers and U.S. futures markets and members of exchanges that are not required to register with the CFTC.

Many of the small and medium-sized FCMs assist America's farmers and producers to control their costs of production. Unfortunately, today we have around ½ the number of FCMs serving our farmers that we had a few years ago. FCMs, particularly smaller ones, are being squeezed by the current environment of low interest rates and increased regulatory burdens. They are barely breaking even. Just this past Thursday, April 9, another FCM exited the futures markets when U.S.-based Jefferies Group announced the sale of its storied Bache Futures business to French bank Société Générale.[6] Like many FCMs, Bache Futures had been struggling with falling fees and high operating costs, including costs of regulatory compliance.

The requirement to retain all written communications that lead to the execution of a transaction in a commodity interest or related cash or forward transaction under rule 1.35 effectively requires commercial end-users that are exchange members to retain every communication connected to a cash market transaction because their cash market transactions may eventually become part of the net exposure of a hedged portfolio. This expanded oversight of the cash market activity of commercial end-users was not called for by Dodd-Frank and discourages exchange membership. It was recently reported that end-users have avoided doing business on Nodal

[2] *Adaptation of Regulations To Incorporate Swaps—Records of Transactions,* 77 FR 75523 (Dec. 21, 2012).

[3] *Id.* and 17 CFR 1.35(a).

[4] *Id.*

[5] *Records of Commodity Interest and Related Cash or Forward Transactions,* 79 FR 68140 (proposed Nov. 14, 2014).

[6] Peter Rudegeair and Angela Chen, *Jefferies to Sell Bache Futures Unit, Buy Forex Ops,* WALL STREET JOURNAL, Apr. 9, 2015, available at *http://www.wsj.com/articles/jefferies-to-sell-bache-futures-unit-buy-forex-ops-1428582402*.

Exchange, a Virginia-based, non-intermediated futures exchange that specializes in electric congestion contracts, due to the rule 1.35 requirements.[7]

We should not be further squeezing American agriculture and manufacturing with increased costs of complying with rules such as 1.35, if we can avoid it. The stated purpose of the Dodd-Frank Act was to reform "Wall Street." Instead, we are burdening "Main Street" by adding new compliance costs onto our farmers, grain elevators and small FCMs. Those costs will surely work their way into the everyday costs of groceries and winter heating fuel for American families, dragging down the U.S. economy. I am supportive of both regulatory and legislative changes to ensure this does not happen.

B. End-Users Captured As "Financial Entities"

Another example of an unreasonable burden placed on end-users is the CFTC interpretation of the Dodd-Frank definition of "financial entity." It has led to the inadvertent capture of many energy firms as "financial entities." As we have seen, imposing banking law concepts onto market participants that are not banks and that did not contribute to the financial crisis is not only confusing, but also adds more risk to the U.S. financial system. It has the practical effect of preventing certain energy firms from taking advantage of the end-user exemption for clearing or from mitigating certain types of commercial risk. Again, let us not punish market participants who played no role in the financial crisis.

*C. Swap Dealer **De Minimis** Level*

Requiring that the Commission take a vote before a major shift in its regulations takes effect seems like a basic tenet of proper administrative law. However, in the CFTC's final rule defining who would be captured as a "swap dealer," the Commission abdicated this responsibility. Instead, the rule allows the "*de minimis*" threshold of $8 billion of swap business per year to automatically lower to $3 billion in only a few short years without any affirmative vote of the Commission. This automatic lowering may occur regardless of the conclusions of a formal study of the matter required by the Commission—even if the study concludes that lowering the threshold is a bad thing to do!

Unquestionably, an arbitrary 60 percent decline in the swap-dealer registration threshold from $8 billion to $3 billion creates significant uncertainty for non-financial companies that engage in relatively small levels of swap dealing to manage business risk for themselves and their customers. It will have the effect of causing many non-financial companies to curtail or terminate risk-hedging activities with their customers, limiting risk-management options for end-users and ultimately consolidating marketplace risk in only a few large swap dealers. Such risk consolidation runs counter to the goal of Dodd-Frank to reduce systemic risk in the marketplace. The CFTC must not arbitrarily change the swap dealer registration *de minimis* level without a formal rulemaking process.

D. Dodd-Frank Act Indemnification Requirements

Under Sections 725, 728 and 763 of the Dodd-Frank Act, when a foreign regulator requests information from a U.S. registered swap data repository (SDR) or derivatives clearing organization (DCO), the SDR or DCO is required to receive a written agreement from the foreign regulator stating that it will abide by certain confidentiality requirements and will "indemnify" the CFTC for any expenses arising from litigation relating to the request for information. In short, the concept of "indemnification"—requiring a party to contractually agree to pay for another party's possible litigation expenses—is only well established in U.S. tort law, and does not exist in practice or in legal concept in many foreign jurisdictions, thereby introducing complications to data-sharing arrangements with foreign governments and raising the possibility of data fragmentation at the international level.

Correcting this unworkable framework in the Dodd-Frank Act is not controversial, and Congress should absolutely provide a legislative fix to this issue, just as the Securities and Exchange Commission (SEC) has endorsed in testimony before Congressional Committees in the 112th Congress. Similarly, in the 113th Congress, H.R. 742 was introduced to provide a narrow fix on this issue and passed the House on June 12, 2013, by a vote of 420–2. The same provision should be included in any CFTC reauthorization legislation introduced by this Congress.

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[7] Alexander Osipovich, *US Record-keeping Rule Hits Commodity Derivatives End-Users*, RISK.NET, Mar. 12, 2015, available at *http://www.risk.net/energy-risk/feature/2399028/us-record-keeping-rule-hits-commodity-derivatives-end-users*.

E. Contracts with Volumetric Optionality

Another topic of concern is risk-management contracts that allow for an adjustment of the quantity of a delivered commodity. These types of contracts, known as "Forward Contracts with Embedded Volumetric Optionality," or EVO Forwards, are important to America's economy. They provide farmers, manufacturers and energy companies with an efficient means of acquiring the commodities they need to conduct their daily business—at the right time and in the right amounts. This includes providing affordable sources of energy to millions of American households. EVO Forwards do not pose a threat to the stability of financial markets. They should not be regulated in the same manner as financial derivatives.

Forwards are expressly excluded from the definition of a "swap" under the Commodity Exchange Act. The CFTC's original guidance on how to determine when an EVO Forward should also be considered a forward, and thus excluded, using a "Seven-Factor Test" has been burdensome, unnecessary and duplicative. The CFTC captured a large swath of transactions that were not and should not be regulated as "swaps," including EVO Forwards.

Fortunately, the Commission last fall proposed through regular order an amended interpretation of the Seven-Factor Test.[8] That proposal is a good start for providing some sensible relief from the problems arising from the test. I believe the best approach would be a new and more practical product definition. Short of that, I am listening carefully to recommendations by consumers and industry for a better interpretation.

If not corrected, the regulation of these transactions will have the effect of increasing companies' costs of doing business. It will force some businesses to curtail market activity and thereby consolidate risk in the marketplace rather than transfer and disperse it. That will ultimately raise costs for consumers. Such expensive and unnecessary regulation thwarts the intent of Congress under the Dodd-Frank Act.

F. Special Entity Utilities

The Dodd-Frank Act requires that American towns and municipalities be labeled as "special entities" when they enter into swaps transactions. The purpose was to provide specific protections for municipalities who used complex financial swaps of the type that ensnared Jefferson County, Alabama, and led it to file what—at the time—was the largest municipal bankruptcy in U.S. history. Congress never intended, however, and Dodd-Frank does not include requirements to limit the ability of our not-for-profit utilities to manage ordinary risks associated with generating electricity or producing natural gas.

Unfortunately, the CFTC's first shot at the "special entity" rule contained onerous restrictions on ordinary risk management activities by America's not-for-profit taxpayer-owned utilities. It generated an enormous amount of public comment. Many commenters asserted that the rule would cause trading counterparties to avoid dealing with special entity utilities due to the increased regulatory compliance and registration burdens of being labeled as a swap dealer. That meant that these utilities would have had far fewer tools to control fluctuations in operational costs or supply and demand, resulting in increased electricity and other energy costs for American consumers.

The CFTC's original special entity proposal also led to two identical pieces of legislation to correct the CFTC's action in Congress, one passed the House unanimously, and the other was introduced in the Senate with 14 cosponsors evenly split between both political parties.

Fortunately, in September of last year, the Commission finalized a rule change that recognized Congressional concern. It provided the relief that our not-for-profit taxpayer-owned utilities need to manage risks in the production of natural gas and electricity. Without the rule change, a regulatory action inspired by the Dodd-Frank Act would have increased utility rates for millions of Americans. In times of economic uncertainty, that would have been an unacceptable result. The legislative solutions offered during the last Congress, however, would still provide added certainty to the marketplace, and I support making the CFTC's regulatory changes permanent in statute.

G. Margin Requirements for Uncleared Swaps

The CFTC's proposed rules on margin for uncleared swaps are inconsistent with the European and IOSCO approach of exempting swaps transactions between cer-

[8] *Forward Contracts With Embedded Volumetric Optionality,* 79 FR 69073 (proposed Nov. 20, 2014).

tain affiliates from having to post initial margin.[9] As a result, the cost of such initial margin in internal risk transfer trades will likely be borne by end-users. This added cost will discourage end-users from entering into swaps transactions with international swaps dealers that, in turn, look to offset the hedge in markets outside of the U.S.

An example is a U.S. auto manufacturer looking to hedge U.S. Dollar/Japanese Yen interest-rate risk through the use of an interest-rate swap provided by a Japanese-headquartered dealer. The added cost of initial margin on that dealer's internal risk transfer trades will likely make that transaction cost-prohibitive for the U.S. end-user, which will instead turn to a domestic dealer without access to the global market offering a necessarily wider bid-offer price spread.

The CFTC's unwillingness to exempt dealer affiliates from having to post margin on uncleared swaps will have two adverse impacts on U.S. end-users: First, it will subject U.S. end-users to higher costs and wider bid-offer price spreads. Second, it will have the effect of ring-fencing financial risk in the U.S. by increasing the costs of risk-hedging in broader global markets.

So, to those who asserted that the CFTC rules were designed to be a barrier to importing risk into the U.S., the effect of the CFTC's unwillingness to exempt internal risk management swaps from initial margin is to encapsulate risk in the U.S. marketplace increasing, rather than decreasing systemic hazard in American financial markets.

H. JOBS Act Harmonization

In letters to the CFTC, stakeholders representing a wide variety of market participants, such as SIFMA, the Managed Funds Association, and the Financial Services Roundtable requested that the Commission harmonize its "private offering" requirements in CFTC rules 4.7 and 4.13(a)(3) with the broadened scope of solicitation permitted by the SEC after it proposed amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933. The SEC's proposed changes to the solicitation rules for securities offerings came about after the Jumpstart Our Business Startups Act (JOBS Act) was signed into law in April 2012,[10] which allows for solicitation of accredited investors for private securities offerings in order to raise needed capital for companies to expand and create jobs. While the JOBS Act mandates consistent treatment of Regulation D, Rule 506 offerings across the Federal securities laws, it unintentionally omitted harmonizing changes to the CFTC's regulations, which created an inconsistency between the SEC's rules and the CFTC's rules governing solicitation.

Because relief was needed quickly so as to not impede use of the JOBS Act by the marketplace, I welcomed CFTC staff letter 14–116 issued on September 9, 2014, to provide relief to market participants from certain provisions of CFTC Regulations 4.7(b) and 4.13(a)(3) restricting marketing to the public.[11] However, because permanent changes to our regulations via statutory language provides the most certainty to the marketplace, I support the inclusion of the language from H.R. 4413 and H.R. 4392 from the last Congress which would provide an exemption for any registered commodity pool operator parallel to the exemption provided for general solicitation of securities under the JOBS Act.

I. Residual Interest Calculation

In March, I welcomed a change to CFTC Rule 1.22 that impacted when residual interest for FCMs would be calculated.[12] Without the recent rule change, the so-called and, perhaps, misnamed "customer protection" rule finalized in October 2013 would likely have resulted in significant harm to the core constituents of this Commission: the American agriculture producers who use futures to manage the every-day risk associated with farming and ranching.

Without the rule change, farmers and ranchers would likely have been forced to prefund their futures margin accounts due to onerous requirements forcing FCMs to hold large amounts of cash in order to pay clearinghouses at the start of trading on the next business day. The increased costs of pre-funding accounts would likely have driven many small and medium-sized agricultural producers out of the market-

[9] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* 79 FR 59898 (proposed Oct. 3, 2014).

[10] Jumpstart Our Business Startups Act, Public Law 112–106, 126 Stat. 306 (2012).

[11] CFTC Letter No. 14–116, *Exemptive Relief from Provisions in Regulations 4.7(b) and 4.13(a)(3) Consistent with JOBS Act Amendments to Regulation D and Rule 144A* (Sep. 9, 2014), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-116.pdf*.

[12] *Residual Interest Deadline for Futures Commission Merchants,* 80 FR 15507 (Mar. 24, 2015).

place. It would likely have forced a further reduction in the already strained FCM community that serves the agricultural community.

When I visited a grain elevator in southern Indiana and a family farm in rural Kentucky last November, I had lunch with around a dozen small family farmers, some of whom use futures products to manage price and production risk. Simply put, they could not fathom why the CFTC would adopt a rule requiring them to pre-fund margin accounts. They saw the former version of our rule as insuring that they would actually lose MORE of their money—not less—in the event of a future failure of another MF Global or Peregrine Financial.

After a significant amount of public comment, and two identical and bipartisan pieces of legislation in both the House and the Senate last Congress, the Commission fortunately amended CFTC Rule 1.22 so that the residual interest deadline does not automatically adjust to the start of business the next morning after a trade, and instead would remain at the close of business the next day following a trade. While the change to this deadline can now only take place after a rulemaking following a public comment period, the legislative solutions offered in H.R. 4413 and S. 2601 during the 113th Congress would go one step further and provide added certainty to the marketplace by not allowing residual interest to be calculated any earlier than the close of business on the next business day following a trade. This approach is especially important given the potential impact on smaller FCMs and the farmers and ranchers who depend on their risk management services.

J. Futures Customer Protections

In H.R. 4413 from the last Congress, there were several provisions that would have made several CFTC and National Futures Association (NFA) regulatory changes permanent in statute to help protect futures customers following the failure of Peregrine Financial and MF Global. Similar to the Commission's recent change improving when residual interest is calculated, I support the important changes H.R. 4413 sought to make requiring that FCMs strengthen their controls over the treatment and monitoring of funds held for customers trading in the U.S. and foreign futures and options markets. In addition, codifying the electronic confirmation of customer funds, which was first proposed by futures industry self-regulatory organizations, and codifying when an FCM must notify regulatory authorities when it faces an undercapitalization scenario would help to protect futures customers from another failure similar to MF Global. Finally, I also support clarifying the definition of customer property to bolster CFTC Regulation 190.08 to ensure farmers and ranchers are not left waiting for months or years to recover their funds held in legally segregated accounts in the event of an FCM insolvency.

II. Derivatives Trading Position Limits

When I joined the Commission 10 months ago, the Energy and Environmental Markets Advisory Committee (EEMAC) had not met since 2009. EEMAC is the only CFTC advisory committee that was formalized in the Dodd-Frank Act. Clearly, Congress believed that it was important to make EEMAC a permanent forum to examine CFTC actions affecting U.S. energy markets. Since the passage of Dodd-Frank, we have had a sea change in the CFTC's influence on U.S. energy markets. At the same time, the markets themselves are undergoing the largest technological and structural changes in a generation. That fact makes EEMAC a critical facility for examining how CFTC regulations impact energy companies, utilities and everyday American consumers.

The CFTC's position-limits proposals are so complex and concerns about them so widespread by stakeholders in U.S. energy markets that they occupied the entire discussion at the first EEMAC meeting on February 26, 2015. The meeting focused on three topics: (1) the data supporting position limits; (2) the likely impact of this rulemaking on liquidity; and (3) the proposed redefinition of *bona fide hedging*.

A. Data Raises Serious Questions

Compelling evidence presented at the EEMAC meeting supports the contention that additional Federal position limits are not necessary in energy markets. The EEMAC heard evidence that the run-up in oil prices before the financial crisis did not bear any of the signs of excessive speculation.[13] This discussion aligns with the same findings made by the CFTC's chief economist in 2008.[14] Similarly, the EEMAC

[13] EEMAC Transcript (Feb. 26, 2015) (EEMAC Tr.) at 29–34.

[14] Dr. Jeffrey Harris, the CFTC's then-Chief Economist, testified before Congress that there was "little evidence that changes in speculative positions are systematically driving up crude oil prices." Tom Doggett, *Congress Told Speculators Not Driving Up Oil Price,* REUTERS, Apr.

Continued

heard powerful evidence that speculators are not responsible for the significant declines in oil prices over the last 9 months.[15]

In fact, Energy Information Administration Administrator Adam Sieminski aptly pointed out that "something had to happen" when the supply of oil in the markets became out of balance with global demand and that "something" was price decline. Both he and University of Houston Professor Craig Pirrong indicated that non-fundamental market factors, such as speculation, played only a negligible, if any, role in the recent sharp decline in domestic and global energy prices. Similarly, another well-informed presenter's analysis asserted that index investors, managed money and swap dealers all had "no discernible impact [or] influence" on oil prices from approximately January 2011 through January 2015.[16]

In addition, the EEMAC heard persuasive testimony that sudden and unreasonable changes in commodity prices flowing from excessive speculation are the ones the CFTC can most readily identify and prosecute using existing tools, such as the ban on manipulation and disruptive trading practices.[17]

1. "Excessive Speculation"

The CFTC has attempted to cast its proposed rules as necessary to curb excessive speculation. Yet, the evidence adduced at the EEMAC meeting suggests otherwise. The CFTC primarily relies on two "black swan" episodes of market manipulation (the Hunt Brothers and Amaranth) in two commodities (silver and natural gas) to find that position limits are necessary in 28 commodities. It is critical to note, however, that market manipulation is generally distinct from excessive speculation. Respected economists highlighted the simple fact that these concepts are "very different."[18] The CFTC has ample tools not only to detect manipulation, but also to punish it.[19]

EEMAC members offered concrete suggestions to address many of the aspects of the proposed rules that simply will not work for the energy markets. These discussions centered on two main concerns: (1) that proposed CFTC position limits may reduce liquidity for hedging purposes; and (2) that the CFTC's approach to *bona fide* hedging is flawed and could put hedgers at risk.

B. Disappearing Liquidity

Exchanges that list energy derivatives explained that, although markets are working well, liquidity is starting to become shallower, particularly along points farther out the curve. Where liquidity is available, wide bid-ask spreads make it increasingly costly and harder to hedge.[20] EEMAC members reported that liquidity is often scarcest in some of the smaller markets, such as regional power and gas markets, where liquidity has started to dry up completely.[21] This reduction of liquidity has resulted from the withdrawal of speculators from the markets.[22]

To prevent further erosion of liquidity at the most critical points, the EEMAC discussed two potential changes to address the negative impact the CFTC's proposal would have on liquidity: accountability and updated deliverable supply.

1. Accountability

The first of these changes would call on the CFTC to utilize a system of position accountability. Position accountability is a process long utilized by futures exchanges—and approved not only by the CFTC but also by Congress[23]—to obtain more detailed information from futures market participants that have reached specified position thresholds. Based on that and other information, the exchange may order the market participant to cap, reduce or even liquidate a position.[24] This tool

3, 2008, available at *http://uk.reuters.com/article/2008/04/03/us-cftc-oil-speculators-idUKN0337748220080403*.

[15] EEMAC Tr. at 36–38.

[16] *See* Thomas LaSala, EEMAC Panel I (Feb. 26, 2015) at 4–7, available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/generic/eemac022615_lasala1.pdf; see also* EEMAC Tr. at 73–78.

[17] EEMAC Tr. at 40.

[18] *Id.* at 16. *See also id.* at 30.

[19] *See, e.g., id.* at 30. *See also Position Limits for Derivatives,* 78 FR 75,680, 75691 and n. 101 (proposed Dec. 13, 2013) (Proposal) (noting complaint against and eventual settlement with Amaranth and Brian Hunter); Kurt Eichenwald, *2 Hunts Fined and Banned from Trades,* NEW YORK TIMES, Dec. 21, 1989, available at *http://www.nytimes.com/1989/12/21/business/2-hunts-fined-and-banned-from-trades.html*.

[20] *E.g., id.* at 81–82, 91–92, 95–96, 103–04, 174–76.

[21] *Id.* at 220–22.

[22] *Id.* at 81–83.

[23] *See* 7 U.S.C. 7(d)(5).

[24] *E.g., id.* at 106.

is essential because, as it was explained at the meeting, "as you get further out the curve, there's naturally less liquidity, less players," while adequate liquidity at those points in the market remains quite important to hedgers.[25]

To guard against concentration risk, futures exchanges monitor market participants—and the market as a whole—carefully when they reach certain levels.[26] Under this careful supervision, market participants may be allowed to exceed the position-limit levels the Commission has proposed. As an added safeguard for use of position accountability, the CFTC also periodically evaluates the adequacy of exchange implementation of position accountability.[27] The exchanges and the CFTC collaborate to ensure that positions across markets are monitored and policed under a position-accountability regime.[28]

The CFTC's position limits proposal gives short shrift to the exchanges' long experience and expertise using position accountability methods to assess the propriety of market participants' positions in light of conditions in the market as a whole, including the depth and shallowness of available liquidity. Indeed, it appears that dismantling this system and replacing it with the CFTC's proposed hard limit levels would undoubtedly harm liquidity in the spot month and beyond, without commensurate enhancement of market integrity.[29]

2. Updated Deliverable Supply

Second, the EEMAC discussed the necessity for the CFTC to review and update its deliverable-supply estimates. The CFTC's proposed deliverable-supply estimates appear deficient in several respects. They must be improved to have any hope of creating a viable position-limits regime. EEMAC heard compelling evidence that deliverable-supply calculations, like so many other aspects of position limits, cannot be done on a "one-size-fits-all" basis. Energy markets have unique characteristics that must be specially considered in calculating deliverable supply.[30]

The CFTC's proposed method of calculating deliverable supply is particularly deficient as to natural gas and electricity because it ignores—and does not permit the exchanges to consider—"supply that is in a different location but can still serve demand in a certain area through transportation of that commodity."[31] This deficiency underscores the need for the CFTC to exercise great care when imposing concepts that may work for agricultural markets, for example, but do not work for energy markets, which function quite differently.[32]

In addition, the deliverable supply estimates the Commission proposes to use are terribly out of date. The Commission proposes to use 1983-vintage deliverable-supply estimates in setting silver and gold spot-month position limits, and 1996-era deliverable-supply estimates for natural gas.[33] We have had a revolution in natural gas exploration and production since the mid-nineties, so it is critical that the CFTC adopt contemporary deliverable-supply estimates.

C. ***Bona Fide*** *Hedging: Risk Management at Risk*

Importantly, the EEMAC meeting also focused closely on the CFTC's sweeping proposals to circumscribe the *bona fide* hedging exemption to position limits. Congress intended that position limits target those who engage in "excessive speculation," while leaving hedgers to their task of reducing risk in their businesses. Unfortunately, the EEMAC heard evidence that the CFTC's proposal unduly focuses on "limiting the activity of commercials in hedging in the markets," which in turn increases the risk of pricing commodities, the cost of which "is ultimately borne by consumers."[34]

Let me briefly summarize a few elements of the CFTC's significant reduction of the *bona fide* hedging exemption:

1. Storage Transactions

In a reversal from its 2011 proposal, the CFTC no longer recognizes as *bona fide* transactions used to hedge risk from storage, transmission or generation of commod-

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[25] *Id.* at 107.

[26] *Id.* at 107–08.

[27] *E.g., Rule Enforcement Review of the Chicago Mercantile Exchange and the Chicago Board of Trade* at 39–50 (Jul. 26, 2013), available at *http://www.cftc.gov/ucm/groups/public/@iodcms/documents/file/rercmecbot072613.pdf.*

[28] EEMAC Tr. at 139–40.

[29] See EEMAC Tr. at 108–12; Proposal, 78 FR at 75839–40 (proposed App. D); Proposal, 78 FR at 75766.

[30] *Id.* at 99–100, 112.

[31] *Id.* at 100, 131–33.

[32] *See, e.g., id.* at 130–33.

[33] CME Comment Letter at 3 (Feb. 20, 2014).

[34] EEMAC Tr. at 157–58, 183.

ities. The EEMAC learned that these transactions form the "bread and butter" of energy industry efforts to hedge risks—and thereby pass along the best possible prices to consumers.[35] Although the CFTC once recognized the legitimacy of this sort of hedge, the new proposal apparently denies *bona fide* hedge treatment because of the fear of abuse in the agricultural sector, where a storage bin could be used for multiple commodities[36]—soybeans and corn, for example. Yet, the proposed rule does not explain why this transaction is unavailable in the energy space, where storage, transmission and generation are obviously not fungible in the same way.[37] I recently toured the Valero refinery in Houston, and it was a fascinating and educational experience. But I did not need to have a chemical engineering degree to understand that liquefied natural gas or generated electricity cannot be stored in a gasoline tank farm. The CFTC rules need to recognize that as well.

2. Merchandising and Anticipatory Hedging

EEMAC members expressed considerable frustration that the CFTC's proposal does not recognize the importance of merchandising and its role in connecting the two ends of the value chain: production and consumption.[38] Moreover, merchandising promotes market convergence, an important component of price discovery and market health.[39] EEMAC members explained that unfixed price contracts are frequently used in merchandising transactions and argued forcefully that the CFTC should re-evaluate its approach to basis contracts.

3. Cross-Commodity Hedges

EEMAC members also raised significant concerns with the CFTC's application of the hedge exemption to cross-commodity hedges. Cross-commodity hedging, such as hedging jet fuel with ultra-low sulfur diesel futures contracts, is currently permitted in the spot month and is critical to the price-discovery process, but would not be permitted under the position-limits proposal.[40] Similarly, EEMAC members stated that the proposed quantitative restriction on cross-commodity hedges was deeply problematic.[41] This proposed quantitative restriction would kill long-used, tried-and-true cross-commodity hedges, including hedging electricity with natural gas and fuel oil with crude oil.[42]

4. Gross *versus* Net Hedging

Finally, EEMAC members raised concerns regarding the CFTC's proposed approach of permitting hedging only on an enterprise-wide level. The EEMAC heard evidence that this approach substitutes regulatory edict for the common-sense business judgments that underlie existing risk-management procedures and hedging programs.[43] The risk-management systems and procedures on which so many hedgers depend were built in reliance on long-standing CFTC interpretations, which this proposal changes suddenly and with questionable justification.[44] In some cases, the CFTC's proposed approach is in tension with other state or Federal regulatory requirements with regard to hedging or reliability.[45]

In short, the Commission and the staff have to think carefully about many aspects of the proposed *bona fide* hedge exemption. I am very concerned that the effect of the CFTC's proposed narrow list of exemptions is to impose a Federal regulatory edict in place of business judgment in the course of risk-hedging activity by America's commercial enterprises. The CFTC instead must allow for greater flexibility. It must encourage commercial enterprises to adapt to developments and advances in hedging practices, not impede their efforts to do so. The CFTC needs to take special care that in chasing excessive speculation, it does not needlessly add unnecessary burdens on hedgers, end-users and consumers—the very participants that Congress intended to protect against excessive speculation.

The position-limits rulemaking is a significant undertaking and both the Commission and its staff are struggling to get it right. I continue to keep an open mind on how the difficult questions raised before the EEMAC should be resolved. I am guided in this endeavor by two major principles. First, we need to follow the data.

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[35] *Id.* at 170–76.
[36] *Id.* 174–75.
[37] *E.g., id.* at 178–79.
[38] *E.g., id.* at 161–62, 190–91, 209.
[39] *E.g., id.* at 191.
[40] *Id.* at 115–16.
[41] *E.g., id.* at 191, 200–03; see also Proposal, 78 FR at 75717–18 (describing quantitative factor and suggesting it should not apply to electricity-natural gas cross commodity hedging).
[42] EEMAC Tr. at 200–03.
[43] *E.g., id.* at 158–60, 186–87, 216–18.
[44] *See id.*
[45] *Id.* at 216–18.

Considering the data and research in the record, significant questions remain as to whether additional Federal position limits are necessary. Even if one accepts that additional Federal limits are necessary, these limits must be appropriate. The only way to make this determination is to draw upon current and accurate data and confirm that the rule proposal will facilitate price discovery, maintain liquidity and not unduly disrupt markets that by all accounts are functioning fairly well. We should all agree that basing such important rule making on twenty or thirty year old data is simply unacceptable in a modern, well-regulated economy.

Second, the Commission must be attentive to the costs and benefits of its rulemaking. There is no doubt that this rule will be very expensive and that hedgers will bear a significant share of the costs. Moreover, as an EEMAC member observed, this rule is likely to result in higher costs for consumers of energy and will be felt most heavily by low-income Americans.[46] Before making a shaky necessity finding, construing an ambiguous statute or even putting in place individual aspects of its proposal, the CFTC needs to undertake a clear-eyed assessment of the costs and benefits associated with expanding the position-limits rule.

III. CFTC Swaps Trading Rules

In January of this year, I issued an extensive white paper analyzing the mismatch between the CFTC's swaps trading regulatory framework and the distinct liquidity and trading dynamics of the global swaps markets.[47]

The white paper asserts that Congress got much of Dodd-Frank's swaps trading rules right. Congress laid out a straightforward and flexible swaps trading regulatory framework well-suited to the episodic nature of swaps liquidity and swaps market dynamics.

Unfortunately, the CFTC's implementation of the swaps trading rules widely misses the Congressional mark. I believe the rules are fundamentally flawed for a number of reasons:

- Because they inappropriately adopt a U.S.-centric futures regulatory model that supplants human discretion with overly complex and highly prescriptive rules;
- Because they are largely incompatible with the distinct liquidity, trading and market structure characteristics of the global swaps markets;
- Because they fragment swaps trading into numerous artificial market segments and drive global market participants away from transacting with entities subject to CFTC swaps regulation;
- Because they exacerbate the already inherent challenge in swaps trading—maintaining adequate liquidity—and thus increase market fragility and the systemic risk that the Dodd-Frank reforms were predicated on reducing; and
- Last, but foremost, because they do not do what Dodd-Frank expressly required them to do. They simply do not comply with the clear provisions of the law.

A. The CFTC's Flawed Swaps Trading Regulatory Framework

Let me highlight a few of the key flaws in the swaps rules, starting with:

1. Limits on Methods of Trade Execution

CFTC rules for SEFs create two categories of swaps transactions: Required Transactions[48] and Permitted Transactions.[49] Required Transactions must be executed in an order book (Order Book)[50] or an RFQ system in which a request for a quote is sent to three participants operating in conjunction with an Order Book (RFQ System).[51] Permitted Transactions allow for any method of execution,[52] but SEFs must also offer an Order Book for such transactions.[53]

There is simply no statutory support for the CFTC's "required" and "permitted" distinction. There is no support for segmenting swaps into two categories or for limiting one of those categories to two methods of execution. Rather, Congress's SEF definition encompasses a platform where *multiple* participants have the ability to execute swaps with *multiple* participants through any means of interstate com-

[46] *Id.* at 196–99.
[47] CFTC Commissioner J. Christopher Giancarlo, *Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank* (Jan. 29, 2015), available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf*.
[48] 17 CFR 37.9(a)(1).
[49] 17 CFR 37.9(c)(1).
[50] 17 CFR 37.3(a)(2), 37.3(a)(3) and 37.9(a)(2).
[51] 17 CFR 37.9(a)(2) and 37.9(a)(3).
[52] 17 CFR 37.9(c)(2).
[53] 17 CFR 37.3(a)(2); *Core Principles and Other Requirements for Swap Execution Facilities,* 78 FR 33476, 33504 (Jun. 4, 2013) (SEF Rule).

merce, including a trading facility.[54] This broad and flexible definition allows execution methods beyond an Order Book or RFQ System for all swaps, not just some swaps. The statutory language contains a *multiple-to-multiple* participant trading requirement, not an *all-to-all* trading requirement. The CFTC Order Book obligation is, simply, made up out of thin air.

Congress further permitted SEFs to offer swaps trading "*through any means of interstate commerce.*"[55] The CFTC rules acknowledge this phrase but construe it narrowly to allow for voice and other "means" of execution only within the limited Order Book and RFQ System execution methods.[56] Yet, the phrase "*interstate commerce*" has a rich and well-developed constitutional history, which U.S. Federal courts have interpreted to cover almost an unlimited range of commercial and technological enterprise.[57] The CFTC's narrow construct is disingenuous and not supported by the courts' long-established interpretation of the Commerce Clause.

Congress could have required SEFs to offer certain limited execution methods but chose not to do so. Congress could have limited swap execution to the trading facility execution method that futures exchanges are required to use.[58] Congress did not do so. Congress could have preserved references to "electronic execution" included in early drafts of the Dodd-Frank Act, but it did not do so in the final statutory text.[59]

Electronic order books may be the standard method of trade execution in the futures markets, but that is not the case with swaps. The SEF definition reflects an understanding that, given swaps' generally episodic liquidity, a broad variety of execution methods are necessary. The Dodd-Frank Act did not seek to alter swaps' natural trading and execution dynamics, so we at the CFTC do not have the authority to do otherwise.

2. Block Transactions

The CFTC block trade definition, specifically, the "occurs away" requirement, is another example of artificial market segmentation. The CFTC defines a block trade as "a publicly reportable swap transaction that: (1) involves a swap that is listed on a registered SEF or DCM; (2) 'occurs away' from the registered SEF's or DCM's trading system or platform; and (3) has a notional or principal amount at or above the appropriate minimum block size applicable to such swap . . . ."[60]

The block trade definition is a holdover from the futures model.[61] In the futures market, block trades occur away from the DCM's trading facility as an exception to the centralized market requirement given the price and liquidity risk of executing these large-sized trades.[62]

In today's global swaps market, however, there are no "on-platform" and "away-from-platform" execution distinctions. Over-the-counter (OTC) swaps trade in very large sizes. These swaps are not constrained to trading facilities, but trade through one of a variety of execution methods appropriate for the product's trading liquidity.

Again, the Dodd-Frank Act recognized these differences by not imposing on SEFs an open and competitive centralized market requirement. Rather, Congress expressly authorized delayed reporting for swap block transactions.[63] Congress got it right.

We at the CFTC have the swaps block trade definition wrong. There is no statutory support for the "occurs away" requirement. The requirement creates an arbi-

[54] CEA section 1a(50); 7 U.S.C. 1a(50).

[55] *Id.*

[56] 17 CFR 37.9(a)(2)(ii); SEF Rule at 33501–02. The Commission states that "in providing either one of the execution methods for Required Transactions in § 37.9(a)(2)(i)(A) or (B) of this final rulemaking (*i.e.,* Order Book or RFQ System that operates in conjunction with an Order Book), a SEF may for purposes of execution and communication use 'any means of interstate commerce,' including, but not limited to, the mail, internet, email, and telephone, provided that the chosen execution method satisfies the requirements provided in § 37.3(a)(3) for Order Books or in § 37.9(a)(3) for Request for Quote Systems." SEF Rule at 33501.

[57] *See, e.g., Gonzales* v. *Raich,* 545 U.S. 1, 17 (2005); *Katzenbach* v. *McClung,* 379 U.S. 294, 302 (1964); *Wickard* v. *Filburn,* 317 U.S. 111, 125 (1942).

[58] CEA section 1a(51); 7 U.S.C. 1a(51).

[59] *Compare* S. 3217, 111th Cong. § 720 (as reported by S. Comm. on Banking, Housing, and Urban Affairs, Apr. 15, 2010) (defining a SEF as "an electronic trading system" and discussing electronic execution of trades), *with* 7 U.S.C. 1a(50) (defining a SEF as "a trading system or platform" without reference to electronic execution).

[60] 17 CFR 43.2.

[61] *See Alternative Executive, or Block Trading, Procedures for the Futures Industry,* 64 FR 31195 (Jun. 10, 1999); *Chicago Board of Trade's Proposal To Adopt Block Trading Procedures,* 65 FR 58051 (Sep. 27, 2000).

[62] 17 CFR 38.500; *Execution of Transactions: Regulation 1.38 and Guidance on Core Principle 9,* 73 FR 54097, 54099 (proposed Sep. 18, 2008).

[63] CEA section 2(a)(13)(E); 7 U.S.C. 2(a)(13)(E).

trary and confusing segmentation between non-block trades "on-SEF" and block trades "off-SEF." The "off-SEF" requirement undermines the legislative goal of encouraging swaps trading on SEFs.[64] In short, it needs to be changed.

3. Made Available to Trade

Congress included a trade execution requirement in the Commodity Exchange Act that requires SEF execution for swaps subject to the clearing mandate.[65] In an innocuous exception to this requirement, Congress stated that the trade execution requirement does not apply if no SEF "makes the swap available to trade."[66]

Based on nothing other than these six words, the CFTC has created an entire new regulatory mandate that is now known as the "made available to trade" or MAT process.[67] Yet, a plain reading of Dodd-Frank's trade execution requirement shows that Congress never intended to create such a regulatory framework around these six words. Unlike the clearing mandate, the trade execution requirement provided no regulatory process for moving some swaps on-SEF and keeping others off.[68]

Congress could have specified a regulatory process for the trade execution requirement as it did for the clearing mandate, but it chose not to. Unlike futures, which begin life on an exchange where they may or may not attract liquidity, newly developed swaps products are initially traded bilaterally and only move to a platform once trading liquidity is assured. Congress's trade execution requirement merely reflects the simple logic that a clearing-mandated swap must be executed on a SEF provided that the particular swap is sufficiently liquid that some SEF makes it available to trade (*i.e.,* offers the swap for trading). This logical condition was not meant to serve as the basis for a new CFTC regulatory process.

This MAT process would not even be necessary if the CFTC allowed SEFs to offer swaps trading through "any means of interstate commerce," exactly as Congress authorized. In short, the MAT process is not supported by the text of Dodd-Frank or the inherent nature of global swaps trading.

Congress should not support the CFTC in any assertion of greater control over the MAT process. Rather, the CFTC should withdraw its MAT regulations and, instead, conform its rules to the express Congressional text of Title VII, permitting SEFs to conduct their operations using such "means of interstate commerce" as they deem most suitable to serve their customer needs in the particular swaps products and marketplaces in which they operate.

4. Impartial Access

Dodd-Frank requires SEFs to have rules to provide market participants with impartial access to the market and to establish rules regarding any limitation on access.[69] For some reason, CFTC staff appear to view these provisions as requiring SEFs to serve every type of market participant in an all-to-all market structure. Given the Dodd-Frank Act's reference to *limitations* on access and its flexible SEF definition, however, efforts to require SEFs to serve every type of market participant in all-to-all marketplaces are unsupportable.

Impartial access must not be confused with open access. Impartial access, as the CFTC noted in the preamble to the final SEF rules, means "fair, unbiased, and unprejudiced" access.[70] This means that a SEF should apply this standard to its participants; it does not mean that a SEF is forced to serve every type of participant in an all-to-all futures-style marketplace. Only Congress could have imposed an all-to-all trading mandate; it chose not to do so.

5. Void *Ab Initio*

CFTC staff has issued guidance stating that any swap trade that is executed on a SEF and that is not accepted for clearing is invalid from the beginning or "void *ab initio.*"[71]

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[64] CEA section 5h(e); 7 U.S.C. 7b–3(e).

[65] CEA section 2(h)(8); 7 U.S.C. 2(h)(8).

[66] *Id.*

[67] CEA section 2(h)(8); 7 U.S.C. 2(h)(8); 17 CFR 37.10, 37.12, 38.11 and 38.12; *Process for a Designated Contract Market or Swap Execution Facility To Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement Under the Commodity Exchange Act,* 78 FR 33606 (Jun. 4, 2013).

[68] *Compare* CEA section 2(h)(1), 2(h)(2) and 2(h)(3); 7 U.S.C. 2(h)(1), 2(h)(2) and 2(h)(3), *with* CEA section 2(h)(8); 7 U.S.C. 2(h)(8).

[69] CEA section 5h(f)(2); 7 U.S.C. 7b–3(f)(2).

[70] SEF Rule at 33508.

[71] Division of Market Oversight and Division of Clearing and Risk, *Staff Guidance on Swaps Straight-Through-Processing* (Sep. 26, 2013), available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/stpguidance.pdf*.

The CFTC's void *ab initio* policy has no support in the Dodd-Frank Act. There are legitimate reasons, such as operational or clerical errors, that cause trades to be rejected from clearing. The void *ab initio* policy creates a competitive disadvantage for the U.S. swaps market relative to the U.S. futures market, which does not have such a policy. Further, the void *ab initio* policy may well introduce additional risk into the system when a participant enters into a series of swaps to hedge its risk but one or more swaps is declared void *ab initio.* In this case, the participant will not be correctly hedged, which creates additional market and execution risk.

6. Core Principles

Congress provided a core principles-based framework for SEFs.[72] Unfortunately, the Dodd-Frank Act missed the mark with respect to the SEF core principles, most of which are based on the DCM core principles.[73] The futures regulatory model is an inappropriate template for SEF core principles. This problem has been magnified by unwarranted amendments to CFTC rules making SEFs self-regulatory organizations (SROs)[74] and requiring them to comply with very prescriptive rules modeled after futures exchange practices that are unsuitable for the way swaps trade. Although the SEF core principles contain certain regulatory obligations, Dodd-Frank did not instruct the CFTC to make SEFs SROs or take a prescriptive rules-based approach. In fact, the statute provides SEFs with reasonable discretion to comply with the core principles.[75] The CFTC should draw on its long and successful experience as a principles-based regulator to implement a flexible core principles-based approach for SEFs that aligns with inherent swaps market dynamics.

I recommend the following changes to the SEF core principles set out in Title VII of the Dodd-Frank Act.

Monitoring of trading and trade processing. SEF Core Principle 4 requires SEFs to monitor trading in swaps to prevent manipulation, price distortion and disruptions of the delivery or cash settlement process, among other things.[76] Certain rules promulgated under Core Principle 4 require a SEF to look beyond its own market to gain the information necessary to perform these functions. For example, CFTC Regulation 37.404(a) requires a SEF to "demonstrate that it has access to sufficient information to assess whether trading in swaps listed on its market, in the index or instrument used as a reference price, or in the underlying commodity for its listed swaps is being used to affect prices on its market."[77] In other words, a SEF that executes a credit default swap on a Ford Motor Company bond must also monitor trading in the underlying Ford Motor Company bonds to prevent manipulation, price distortion and disruption in its market. While a SEF has the ability to monitor trades it executes, asking it to monitor manipulation in another marketplace in which it may provide no execution services is an undue, unfair and unwarranted burden.

The CFTC acknowledges this challenge. Its website regarding market surveillance states that only the CFTC itself can "consolidate data from multiple exchanges and foreign regulators to create a seamless, fully-surveilled marketplace" due to its unique space in the regulatory arena.[78] The surveillance "requires access to multiple streams of proprietary information from competing exchanges, and as such, can only be performed by the Commission or other national regulators."[79] The CFTC correctly states that the surveillance "cannot be filled by foreign and domestic exchanges offering related competing products,"[80] and there is no reason to believe that a SEF is better situated. And yet, despite this broad disclaimer, each SEF that fails to fulfill this sort of surveillance function will be in violation of SEF Core Principle 4 and CFTC rules.

Congress should clarify SEF Core Principle 4 to make clear that a SEF is not required to monitor markets beyond its own.[81] The CFTC should also revise its rules to this effect. As the CFTC admits on its website, only it can perform cross-market surveillance.

[72] CEA section 5h(f); 7 U.S.C. 7b–3(f).
[73] CEA section 5(d); 7 U.S.C. 7(d).
[74] 17 CFR 1.3(ee). *Adaptation of Regulations to Incorporate Swaps,* 77 FR 66288, 66290 (Nov. 2, 2012).
[75] CEA section 5h(f)(1)(B); 7 U.S.C. 7b–3(f)(1)(B).
[76] CEA section 5h(f)(4); 7 U.S.C. 7b–3(f)(4).
[77] 17 CFR 37.404(a).
[78] CFTC Market Surveillance Program, available at *http://www.cftc.gov/IndustryOversight/MarketSurveillance/CFTCMarketSurveillanceProgram/tradepracticesurveillance*.
[79] *Id.*
[80] *Id.*
[81] CEA section 5h(f)(4); 7 U.S.C. 7b–3(f)(4).

Position limits. SEF Core Principle 6 places the burden for position limits and position accountability levels on SEFs that are trading facilities.[82] The Dodd-Frank Act got this core principle wrong.

The setting of position limits or position accountability levels by SEFs is very problematic. As I explained in my white paper, SEFs do not own swaps products, which trade on multiple competing SEFs and bilaterally off-SEFs. SEFs lack knowledge of a market participant's activity on and off other venues. SEFs only have information about swaps transactions that occur on their platforms and thus do not know whether a particular transaction on their platform adds to, or offsets all or part of, a participant's existing position. Therefore, SEFs are not able to calculate the total position of a market participant or monitor it against any position limit. As explained in the Core Principle 4 discussion above, only a markets regulator, such as the CFTC, that has a full picture of the market can perform cross-market monitoring and surveillance functions. Position-limit monitoring and surveillance is another such area.

Congress should revise Core Principle 6 to reflect that the CFTC, or possibly a designee, should set and monitor swaps position limits or accountability levels. Until Congress revises this futures-based core principle, the CFTC staff should continue to work with SEFs to derive a solution that ameliorates this burden on SEFs. Any regulatory demand that SEFs set or monitor limits or levels is an impossible exercise that adds extraordinary costs.

Emergency authority. SEF Core Principle 8 requires a SEF to "adopt rules to provide for the exercise of emergency authority . . . including the authority to liquidate or transfer open positions in any swap . . . ."[83] In its current form, this futures-based core principle places an impossible burden on SEFs. Congress should revise it to better suit the realities of the swaps market.

A SEF does not have the ability to liquidate or transfer open swaps positions because SEFs do not hold positions on behalf of their participants. As several commenters to the final SEF rules have explained, a SEF is not the appropriate entity to order the liquidation or transfer of these positions in an emergency because it does not have the ability or legal right to do so.[84] The CFTC or a DCO, for cleared swaps, for example, are more appropriate entities to exercise this authority. Until Congress revises this futures-based core principle, the Commission and its staff should work to revise CFTC guidance under SEF Core Principle 8 to at most require a SEF to adopt rules for coordination with a DCO or the CFTC to facilitate the liquidation or transfer of open positions in an emergency.[85]

Financial resources. SEF Core Principle 13 requires a SEF to have "financial resources [in an amount that] exceeds the total amount that would enable the [SEF] to cover the operating costs of the [SEF] for a 1 year period, as calculated on a rolling basis."[86]

The market impact of a SEF failure is not nearly comparable to the effect of a DCM failure, so it does not make sense for a SEF to hold 1 year of financial resources. A SEF failure will not likely create a liquidity crisis because most swaps trade on multiple SEFs, and there are multiple liquidity pools available in which to trade. Participants can easily trade on another SEF in the event of a failure. This is in contrast with the futures market, where the impact on market liquidity is of greater concern in the event of a DCM failure because a DCM owns its products and those products only trade on that specific DCM. Thus, there is one liquidity pool. The failure of one DCM will likely harm this liquidity unless regulators take action to transfer those products and the corresponding open interest to another DCM or participants move to another product on another DCM. Given these differences, SEFs should not be held to the same 1 year financial-resources requirement as DCMs.

The financial-resources requirement is overly burdensome and disproportionately impacts SEFs that offer voice-based execution methods. These SEFs must significantly increase their financial resources to cover the compensation of employee brokers who facilitate execution through these voice-based methods.[87] This requirement

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[82] CEA section 5h(f)(6); 7 U.S.C. 7b–3(f)(6).

[83] CEA section 5h(f)(8); 7 U.S.C. 7b–3(f)(8).

[84] SEF Rule at 33536.

[85] *Id.*

[86] CEA section 5h(f)(13); 7 U.S.C. 7b–3(f)(13).

[87] It is a common practice in traditional voice brokerage firms for the bulk of compensation of client-facing personnel to be calculated as a percentage of transaction commissions generated and collected by the employer. Such aggregate compensation is often one of the largest components of operating costs at such firms.

ties up additional capital for these SEFs, which puts them at a competitive disadvantage.

Congress should reexamine this core principle and only require a SEF to hold enough capital to conduct an orderly wind-down of its operations. It would not take a SEF 1 year to terminate employees and contracts and conduct an orderly wind-down of its operations. It would not be unreasonable to expect a SEF to conduct such a wind-down in 3 months.[88] This approach would release significant capital back to the SEF for innovation, lower barriers to entry, reduce costs and increase competition.

In the meantime, the Commission and staff should reexamine CFTC rules and work with SEFs to reduce their financial burden. The Commission and staff could, for example (1) flexibly interpret a SEF's financial resources to include additional resources such as projected revenues or projected capital contributions, (2) flexibly interpret operating costs to mean wind-down costs or to exclude certain costs not directly tied to core principle compliance or (3) flexibly interpret operating costs to exclude compensation that is not payable unless and until collected by the SEF.

B. Adverse Consequences of the CFTC's Swaps Trading Regulatory Framework

I have reviewed some of the chief flaws in the CFTC swaps trading rules. Let me now address some of the adverse consequences for U.S. financial markets.

Non-U.S. person market participants' efforts to avoid the ill-designed U.S. swaps trading rules are fragmenting global swaps markets between U.S. persons and non-U.S. persons and driving away global capital.[89] This phenomenon is fostering smaller, disconnected liquidity pools and less efficient and more volatile pricing. Market fragmentation is exacerbating the inherent challenge of swaps trading—maintaining adequate liquidity.

Divided markets are more brittle, posing a risk of failure in times of economic stress or crisis. Fragmentation increases firms' operational risks as they structure themselves to avoid U.S. rules and now must manage multiple liquidity pools in different jurisdictions. Fragmentation also increases trading firms' operational and structural complexity and reduces their efficiency in the markets. In short, market fragmentation caused by the CFTC's ill-designed trading rules—and the application of those rules abroad—is harming liquidity and increasing the systemic risk that the Dodd-Frank Act was predicated on reducing.

In addition to global market fragmentation, the CFTC's unwarranted slicing and dicing of swaps trading into a series of novel regulatory categories, such as Required Transactions and Permitted Transactions and block transactions "off-SEF" and non-blocks "on-SEF," each with their corresponding execution methods, has fragmented domestic swaps trading into an artificial series of smaller and smaller pools of trading liquidity, increasing market inefficiencies. So long as such disparate segments remain, U.S. swaps markets face a CFTC-imposed liquidity challenge compared with non-U.S. markets.

The CFTC's swaps trading regime is also threatening the survival of many SEFs. The CFTC's prescriptive and burdensome rules have ensured that operating a SEF is an expensive, legally intensive activity.[90] This may drive consolidation in the industry, providing trading counterparties with less choice of where and how to execute swaps transactions.

Further, the swaps trading rules are hindering technological innovation. In 1899, U.S. Patent Commissioner Charles H. Duell is said to have pronounced that "everything that can be invented has been invented."[91] Not to be outdone, the CFTC's SEF rules pre-suppose that order book and RFQ methodologies are today and will always remain the only suitable technological means for U.S. swaps execution. These restrictive SEF rules close U.S. swaps markets to promising technological development while the rest of the world proceeds ahead in financial market innovation.

The application of certain CFTC rules threatens jobs in the U.S. financial services industry. As explained above, the CFTC's November 2013 Staff Advisory imposed

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[88] *See, e.g.,* CME Comment Letter to SEF Rule, Appendix A, at 37 (Mar. 8, 2011), available at *http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31276&SearchText=CME* (stating that 3 months is an appropriate time frame for winding-down operations).

[89] *See* ISDA Update. *See also* Amir Khwaja, *A Review of 2014 U.S. Swap Volumes and SEF Market Share,* TABB FORUM (Jan. 16, 2015), available at *http://tabbforum.com/opinions/a-review-of-2014-us-swap-volumes-and-sef-market-share*.

[90] Catherine Contiguglia, *Sef Boss Spends His Days 'Worrying About Costs,'* RISK.NET, Sep. 24, 2014, available at *http://www.risk.net/risk-magazine/news/2371788/sef-boss-spends-his-days-worrying-about-costs*.

[91] Charles Holland Duell, Wikipedia, available at *http://en.wikipedia.org/wiki/Charles_Holland_Duell*. The statement has been debunked as apocryphal.

swaps transaction rules on trades between non-U.S. persons whenever anyone on U.S. soil "arranged, negotiated, or executed" the trade.[92] While the Staff Advisory has been delayed for the fourth time, it is causing many overseas trading firms to consider cutting off all activity with U.S.-based trade-support personnel to avoid subjecting themselves to the CFTC's flawed swaps trading rules.[93] The Staff Advisory jeopardizes the role of bank sales personnel in U.S. financial centers like Boston, Charlotte, Chicago, New Jersey and New York. It will likely have a ripple effect on technology staff supporting U.S. electronic trading systems, along with the thousands of jobs tied to the vendors who provide food services, office support, custodial services and transportation to the U.S. financial services industry. With tens of millions of Americans falling back these days on part-time work, the CFTC should not cause good-paying full-time jobs to be eliminated.[94]

The swaps rules also appear to contain an unstated bias against human discretion in swaps execution. The bias is seen in a range of CFTC positions, such as:

- Allowing only two specific types of execution methods for Required Transactions;[95]
- Requiring an RFQ System to operate in conjunction with an Order Book;[96]
- Requiring an RFQ to be sent to three market participants;[97]
- Placing various conditions around basis risk mitigation services;[98] and
- Showing aversion to Dutch Auction systems that utilize professional discretion in setting auction prices.[99]

Yet, there is just no legal support in Title VII of Dodd-Frank for restricting human discretion in swaps execution.

Is it not odd that, while the CFTC has been restrictive of human interaction in swaps markets, the U.S.'s most successful financial marketplace—the IPO market—is trumpeting the importance of "human touch" in its market?[100] They assert the human element as a key safeguard against the type of runaway technical errors that plagued Facebook's 2012 IPO, when more than 30,000 buy and sell orders were either canceled or delayed.[101] It would be a regulatory failure to restrict human involvement and interaction in the $691 trillion swaps markets and herd trading onto automated electronic platforms, where software failures and technical glitches could someday cause a "flash crash" unlike anything yet seen in global markets.

In a peculiar twist, the CFTC's insistence upon RFQ systems and centralized, order-driven markets to execute swaps transactions has the potential to open U.S. swaps markets to algorithmic and high-frequency trading (HFT), which are not currently a factor in swaps markets. It is unclear how those who support the CFTC's impetus for electronic central limit order book (CLOB) execution of swaps, yet decry HFT in today's equities and futures markets, will reconcile these views when the enormous but human-managed swaps markets are launched into unmanned hyperspace by HFT algorithmic trading technologies.

For these reasons and more that I have set out in my white paper, I am of the firm view that key elements of the CFTC swaps trading rules:

- Do not accord with Congressional intent;
- Have not enhanced market transparency; and

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[92] CFTC Staff Advisory No. 13–69.

[93] CFTC Letter No. 14–140, *Extension of No-Action Relief: Transaction-Level Requirements for Non-U.S. Swap Dealers* (Nov. 14, 2014), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-140.pdf*.

[94] News Release, *The Employment Situation—September 2014,* Bureau of Labor Statistics, at Summary Table A, Oct. 3, 2014, available at *http://www.bls.gov/news.release/archives/empsit_10032014.pdf;* Steve Moore, *Under Obama: One Million More Americans Have Dropped Out Of Work Force than Have Found a Job,* FORBES, Oct. 6, 2014, available at *http://www.forbes.com/sites/stevemoore/2014/10/06/under-obama-one-million-more-americans-have-dropped-out-of-work-force-than-have-found-a-job/*.

[95] 17 CFR 37.9(a)(2).

[96] *Id.* and 17 CFR 37.9(a)(3).

[97] 17 CFR 37.9(a)(3).

[98] *See* CFTC Letter No. 13–81, *Time-Limited No-Action Relief from Required Transaction Execution Methods for Transactions that Result from Basis Risk Mitigation Services* (Dec. 23, 2013), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-81.pdf*.

[99] Apparently, an objection of the CFTC staff to Dutch Auction swap execution is that brokers have discretion in finding price points at which to commence an auction.

[100] Sam Mamudi, *Nasdaq Tries Human Beings to Stave Off IPO Poaching by Bid Board,* BLOOMBERG, Jan. 6, 2015, available at *http://www.bloomberg.com/news/2015-01-06/nasdaq-highlights-human-touch-in-ipo-process-to-fend-off-nyse.html*.

[101] *Id.*

- Have not decreased the systemic risk that the Dodd-Frank Act was premised on reducing.

C. A Swaps Trading Regulatory Framework Consistent with Title VII of Dodd-Frank

I have proposed an alternative swaps trading regulatory framework that is pro-reform and fully aligned with the express statutory framework of Title VII of the Dodd-Frank Act. My proposed swaps regulatory framework is built upon five key tenets:

- Comprehensiveness;
- Cohesiveness;
- Flexibility;
- Professionalism; and
- Transparency.

The first tenet is to subject a comprehensive range of U.S. swaps trading activity to CFTC oversight. My approach supports the CFTC's broad SEF requirement for registration,[102] but insists that the scope of regulatory coverage be fully set forth in clear and definitive rule text and not buried in footnotes, staff advisories or no-action letters.

As of April 9, 2015, CFTC staff has had to issue 258 no-action letters, 56 exemptive letters and 43 statements of guidance, interpretation and advice to implement the Dodd-Frank mandates. That is a total of 357—and counting—miscellaneous communications without formal CFTC rulemaking. There is something clearly wrong with our swaps regulatory framework if it requires that much staff work to put it in place. We need a better set of rules.

The second tenet is regulatory cohesiveness. We must remove the CFTC's artificial slicing and dicing of swaps markets. We must do away with these odd categories of Required Transactions and Permitted Transactions and with block transactions "off-SEF" and non-blocks "on-SEF." Instead, all CFTC-regulated swaps trading should fall within the same cohesive and undivided regulatory framework.

The third tenet is flexibility. The CFTC must adhere to Dodd-Frank's express prescription for flexibility in swaps trading.[103] That means that swaps market participants must be allowed to choose from the broadest possible array of methods of swaps execution that comply with the statutory SEF definition. Those include:

- Electronic CLOBs;
- Simple order books;
- RFQ systems;
- Electronic Dutch Auctions;
- Hybrid electronic and voice execution methods;
- Full voice-based execution methods; and
- Work-up.

It also includes any other "means of interstate commerce" that may today or someday in the future satisfy swaps customer trading and liquidity requirements. U.S. swaps markets must be reopened to business and technological innovation. Technology is improving American lives today in many ways, from hailing a taxi with Uber to connecting with business colleagues on LinkedIn. Technological innovations are also transforming capital markets in areas such as raising money for business start-ups through Kickstarter and consumer borrowing through Payoff. These innovations lower barriers to entry, reduce costs and open markets to a broader range of participants. Unfortunately, the CFTC's swaps rules would prevent such technological innovation in the U.S. swaps markets.

Customer choice and technological innovation, not regulators, must determine the various means of interstate commerce utilized in the swaps market. That is clearly what Congress intended. That is surely the American way.

As I have recommended, the CFTC should do away with its unworkable MAT process, which is not authorized by Dodd-Frank. Yet, eliminating the MAT process will only work if SEFs are allowed to offer swaps execution through "any means of interstate commerce." This approach would also give a plain reading to the requirement for *impartial* access that does not confuse it with a mandate for *open* access. Dodd-Frank did not call into being any particular swaps market structure, such as existing separate dealer-to-dealer and dealer-to-customer markets or combined all-

[102] 17 CFR 37.3(a)(1); SEF Rule at 33481–83.
[103] CEA section 1a(50); 7 U.S.C. 1a(50).

to-all markets. Therefore, regulators must leave participants in the marketplace to determine the optimal market structure based on their swaps trading needs and objectives.

This approach would also better accommodate established and beneficial swaps market practices. It would allow SEFs to implement clear, workable error-trade policies to address the situation where an executed swaps transaction is rejected from clearing. It would end the void *ab initio* policy, which is not statutorily sound. The proposal would further treat the SEF core principles as true principles as Congress intended and not as rigid rule sets.

The fourth tenet of my alternative framework is to enhance professionalism in the swaps market by setting standards of conduct for swaps market personnel. This is consistent with the current approach of advanced overseas regulators, such as the UK's Financial Conduct Authority, that look to supervise professional behavior in overseas financial markets. Rather than implementing highly prescriptive swaps trading rules here in the U.S. that limit intermediaries' discretion, my approach is to establish standards that would enhance the knowledge, professionalism and ethics of personnel in the U.S. swaps markets who exercise discretion in facilitating swaps execution.

It is remarkable that today, if you want to trade a share of Microsoft, you go to a broker who has passed a Series 7 exam confirming his or her product knowledge, skills and abilities in the marketplace.[104] If you want to trade corn futures on the CME you may speak to an IB who has passed the Series 3 exam confirming his or her futures-markets proficiency.[105] Yet, brokers handling billion-dollar CDS and interest-rate swap trades are not required to pass any exams whatsoever.

In the U.S. there is currently no standardized measurement of one's knowledge and qualification to act with discretion in the largest and, arguably, most systemically important financial market—swaps. My proposal would look to established precedents, such as the NFA's Series 3 exam and rules for IBs and other members, as well as FINRA's Series 7 exam and rules for broker-dealers, as guides and modify them to apply to swaps trading and markets.

But enhancing the professionalism of swaps brokers is only worth doing if they are allowed to exercise professional discretion in flexible methods of swaps execution as Congress intended. It is surely pointless and unsupportable otherwise.

The last tenet of my framework focuses on promoting swaps trading and market liquidity as a prerequisite to increased transparency. To date, pre-trade price transparency has been greatly emphasized to the detriment of liquidity in the swaps trading rules. Yet, no meaningful increase in swaps market transparency has been achieved by CFTC rules requiring Order Books that few are using. Requiring Order Books was not how Dodd-Frank balanced the goals of SEF trading.

The right way to promote price transparency is through a proportioned focus on promoting swaps trading and market transparency, as Congress intended. Instead of taking a prescriptive approach to swaps execution that drives away participants, this framework would allow the market to innovate and provide execution through "any means of interstate commerce." That way, participants could choose the execution method that meets their needs based upon a swap's liquidity characteristics, which in turn, would promote trading on SEFs and liquidity. In other words, promoting swaps trading and market liquidity will lead to the enhanced price transparency that Congress sought to achieve.

Many of the adverse consequences of the CFTC's swaps trading rules could be reversed if the rules were redesigned to be much simpler and more effective and if they were in accord with the clear provisions of Title VII of the Dodd-Frank Act.

A smarter and more flexible swaps regulatory approach would eschew the artificial slicing and dicing of U.S. trading liquidity and unwarranted restrictions on means of execution that are unsupported by the law. Rather, it would enable the U.S. to take the global lead in measured and smart regulation of swaps trading. It would allow American businesses to more efficiently hedge commercial risks, promoting economic growth. It would stimulate the American economy and job creation.

For decades the CFTC has been a competent and effective regulator of U.S. exchange-traded derivatives. The opportunity is at hand to continue that excellence in regulating swaps markets. It is time to seize that opportunity.

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[104] *See* Financial Industry Regulatory Authority (FINRA), General Securities Representative Qualification Examination (Series 7) Content Outline (2014), available at *http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/industry/p124292.pdf*.

[105] *See* National Futures Association (NFA), NFA, Examination Subject Areas National Commodity Futures Exam, available at *http://www.nfa.futures.org/NFA-registration/study-outlines/SO-Series3.pdf*.

IV. Cross-Border Impact of Derivatives Regulation

At the 2009 Pittsburgh G20 Summit, global leaders agreed to work together to support economic recovery through a "Framework for Strong, Sustainable and Balanced Growth."[106] The G20 leaders agreed upon three fundamental principles[107] for OTC derivatives markets: (1) moving many bilateral swaps to CCPs for clearing; (2) where appropriate, trading all standardized OTC derivative contracts on regulated trading platforms; and (3) reporting swap trades to trade repositories.[108] To achieve these common goals, the Pittsburgh participants pledged to work together to "implement global standards" in financial markets, while rejecting "protectionism."[109] I am pleased to note that Chairman Massad and CFTC staff, especially the CFTC's Division of Clearing and Risk, have made it a priority to work constructively and collaboratively with our international counterparts to achieve the goals set out in the G20 commitments. Yet, many challenges remain in coordinating global efforts to reform the derivatives markets.

A. Clearinghouse Recognition and Regulation

One of the most critical cross-border issues currently facing the CFTC is U.S. clearinghouse recognition by the European Commission. The EC has not recognized U.S. CCPs as equivalent under the European Market Infrastructure Regulation (EMIR), as it has for CCPs in Japan, Hong Kong, Australia and Singapore.[110] If the EC does not recognize U.S. CCPs as equivalent by June 15, 2015, they will not be classified as "qualifying" CCPs for purposes of Basel III risk-weighting for banking institutions. This will make it cost-prohibitive for EU banks to clear through U.S. CCPs, which will be unable to maintain direct clearing member relationships with EU firms and will be ineligible to clear contracts subject to the EU clearing mandate later this year.[111]

Needless to say, this outcome will be destructive to both U.S. and European economic interests and lead to further market fragmentation and contraction of liquidity, market disruption and dislocation in the global derivatives markets.

This issue remains unresolved despite the fact that the U.S. has adopted global clearing standards. The CFTC adopted the CPMI–IOSCO Principles for Financial Market Infrastructures (PFMIs) in December 2013.[112] The CFTC also patterned its swaps clearing rules on its rules for clearing futures, which have worked successfully for decades.[113] The CFTC's rules do not require that swaps clearing take place in the United States, even if the swap is in U.S. dollars and between U.S. persons. But the CFTC does require that swaps clearing take place on a CFTC-registered and supervised clearinghouse or CCP that meets core principles and basic standards, including the PFMIs. The CFTC's approach is drawn from its successful record of respecting the integrity of the parallel regulatory regimes that govern the clearing activities of dually registered U.S.-EU CCPs.[114]

Yet, this lack of coordination in swaps clearing does not exist in a vacuum. It follows on the heels of an uncoordinated approach to the regulation of swaps trading.

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[106] G20 Leaders' Statement, The Pittsburgh Summit at 2 (Sept. 24–25, 2009) (G20 Statement), available at *http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.*

[107] In addition, the G20 leaders agreed on a fourth principle: that non-centrally cleared derivatives should be subject to higher capital requirements.

[108] G20 Statement at 9.

[109] *Id.* at 7.

[110] Press Release, *First 'Equivalence' Decisions for Central Counterparty Regulatory Regimes Adopted Today,* European Commission, Oct. 30, 2014, available at *http://europa.eu/rapid/press-release_IP-14-1228_en.htm.*

[111] Article 4(88) of the EU Capital Requirements Regulation provides that a CCP is not qualified unless it is authorized in accordance with Article 14 of EMIR or recognized pursuant to Article 25 of EMIR. Pursuant to EU CRD IV, trades cleared with a non-qualified CCP are subject to significant capital charges.

[112] CFTC regulations have fully implemented the PFMIs. *See Derivatives Clearing Organizations and International Standards,* 78 FR 72476 (Dec. 2, 2013).

[113] *See Derivatives Clearing Organization General Provisions and Core Principles,* 76 FR 69334 (Nov. 8, 2011); *Enhanced Risk Management Standards for Systemically Important Derivatives Clearing Organizations,* 78 FR 49663 (Aug. 15, 2013).

[114] The CFTC has not required that dually registered U.S.-EU CCPs apply what is referred to as the "FCM" or "agency" model of clearing to intermediaries that are not CFTC-registered FCMs. This enables the non-U.S. intermediaries of dual registrants to continue to clear "back-to-back" transactions. Similarly, while CFTC regulations prohibit a registered CCP from imposing a minimum capital requirement of more than $50 million on clearing members, the CFTC does not require that U.S.-EU dual registrants apply this standard to non-U.S. and non-FCM clearing members.

B. Swaps Trading

I believe the CFTC started the current rift in cross-Atlantic swaps cooperation with its July 2013 "Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations" (Interpretive Guidance).[115] In essence, the Interpretive Guidance asserted that every single swap a U.S. person enters into, no matter where it is transacted, has a direct and significant connection with activities in, and effect on, commerce of the United States, which requires imposing transaction rules of the CFTC.

Several months later, the CFTC issued a "Staff Advisory" that declared that, even if no U.S. person is a party to the trade, CFTC trading rules apply if it is "arranged, negotiated, or executed" by personnel or agents of a non-U.S. swap dealer located in the U.S.[116]

Taken together, these CFTC pronouncements say that CFTC trading rules apply anytime and anywhere a U.S. person is a party to a swaps trade or the trade is assisted from U.S. shores.

Making things worse, the CFTC swaps trading rules contain a host of peculiar limitations based on practices in the U.S. futures markets that I have describe in my January 29, 2015 white paper and are summarized elsewhere in this Testimony. Many of these limitations have not been adopted in the EU[117] or anywhere else. Several of these peculiar CFTC swaps trading rules are contrary to common practice in global markets and are unlikely to be replicated by non-U.S. regulators.

The combined effect of the CFTC's Interpretive Guidance and Staff Advisory[118]—neither of which is a formally adopted CFTC rule—is to dictate that non-U.S. market operators and participants must abide by the CFTC's peculiar, one-size-fits-all swaps transaction-level rules for trades involving U.S. persons or supported by U.S.-based personnel.

The avowed purpose of the CFTC's broad assertion of jurisdiction is to insulate the United States from systemic risk. Yet, on the ostensible grounds of ring-fencing the U.S. economy from harm, the CFTC purports to tell global swaps markets involving U.S. persons to adopt particular CFTC trading mechanics that do almost nothing to reduce counterparty risk. In the words of one former senior CFTC advisor, the Interpretive Guidance "yoked together rules designed to reduce risk with rules designed to promote market transparency. Yet it provided almost no guidance about how to think about the extraterritorial application of market transparency rules independent of risk. As a result, [the CFTC prescribed] how to apply U.S. rules abroad based on considerations that are tangential to the purposes of those rules."[119]

C. Market Fragmentation

This uncoordinated approach to the regulation of swaps execution and the CFTC's problematic swaps trading regulations have fragmented global markets. Traditionally, users of swaps products chose to do business with global financial institutions based on factors such as quality of service, product expertise, financial resources and professional relationship. Now, those criteria are secondary to the question of the institution's regulatory profile. Non-U.S. person market participants are avoiding financial firms bearing the scarlet letters of "U.S. person" in certain swaps products to steer clear of the CFTC's problematic regulations. Non-U.S. person market participants' efforts to escape the CFTC's flawed swaps trading rules are fragmenting global swaps markets between U.S. persons and non-U.S. persons and driving away global capital.

Since the start of the CFTC's SEF regime in October 2013 and accelerating with mandatory SEF trading in February 2014, global swaps markets have divided into separate trading and liquidity pools between those in which U.S. persons are able

[115] 78 FR 45292 (Jul. 26, 2013).

[116] CFTC Staff Advisory No. 13–69 (Nov. 14, 2013), available at *http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-69.pdf*.

[117] Consultations are still underway under MiFID II and MiFIR.

[118] In addition, the Division of Market Oversight issued Guidance on November 15, 2013, stating that it "expects that a multilateral swaps trading platform located outside the United States that provides U.S. persons or persons located in the U.S. (including personnel and agents of non-U.S. persons located in the United States) . . . with the ability to trade or execute swaps on or pursuant to the rules of the platform, either directly or indirectly through an intermediary, will register as a SEF or DCM." Division of Market Oversight, Guidance on Application of Certain Commission Regulations to Swap Execution Facilities at 2 (Nov. 15, 2013), available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/dmosefguidance111513.pdf*.

[119] Timothy Karpoff, *The Smart Way to Regulate Overseas Swaps Trading,* AMERICAN BANKER (Jul. 21, 2014), available at *http://www.americanbanker.com/bankthink/*.

to participate and those in which U.S. persons are shunned. Liquidity has been fractured between an on-SEF, U.S. person market on one side and an off-SEF, non-U.S. person market on the other.

According to a survey conducted by the International Swaps and Derivatives Association (ISDA), the market for euro interest-rate swaps (IRS) has effectively split.[120] Volumes between European and U.S. dealers have declined 77 percent since the introduction of the U.S. SEF regime.[121] The average cross-border volume of euro IRS transacted between European and U.S. dealers as a percentage of total euro IRS volume was 25 percent before the CFTC put its SEF regime in place and has fallen to just nine percent since.[122]

Rather than controlling systemic risk, the fragmentation of global swaps markets into regional ones is increasing risk by Balkanizing pools of trading liquidity and market pricing.

With the CFTC's swaps trading regime dividing trading in global swaps markets between U.S. persons and non-U.S. persons, we cannot risk further dividing U.S. and European markets in derivatives clearing. That would be the effect if the EC does not recognize U.S. CCPs as equivalent under EMIR.

Now, I can fully understand if some observers of the European resistance to CCP equivalence are reminded of the old idiom, "turnabout is fair play." If the American regulators can overreach when it comes to swaps execution, why should European regulators not overreach on swaps clearing?

D. The Smoot-Hawley Tariff Act of 1930

I have previously likened the current circumstance to the situation after passage by the U.S. Congress of the infamous Smoot-Hawley Tariff Act of 1930, which steeply hiked tariff rates on over 3,300 categories of imported agricultural and manufactured goods.[123] Smoot-Hawley came into effect just as the United States was descending into the Great Depression. Promoters of the law said it was necessary to raise U.S. agricultural prices and help American farmers.[124] They gave little consideration to what the international reaction would be to the higher tariffs.[125]

Smoot-Hawley did not cause America's Great Depression, but it made it worse than it might otherwise have been by contracting both U.S. imports and exports and inviting harsh retaliation.[126] It surely failed in its promised objective of increasing U.S. farm income.[127]

Instead, through Smoot-Hawley the U.S. abdicated economic leadership and poisoned commercial relations with its major trade partners.[128] Smoot-Hawley was interpreted as a declaration of trade war at a critical time in the world economy. Smoot-Hawley made the U.S. a special target of discriminatory trade retaliation from some of the U.S.'s largest and most important trade partners.[129] It led other countries to form preferential trading blocs that discriminated against the United States, diverting world trade and delaying economic recovery on both sides of the Atlantic.[130]

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[120] See International Swaps and Derivatives Association, *Revisiting Cross-Border Fragmentation of Global OTC Derivatives: Mid-year 2014 Update,* ISDA Research Note (Jul. 2014) (ISDA Update), available at *http://www2.isda.org/functional-areas/research/research-notes/*. See also Phillip Stafford, *US Swaps Trading Rules Have "Split Market,"* FINANCIAL TIMES (Jan. 21, 2014), available at *http://www.ft.com/intl/cms/s/0/58251f84-82b8-11e3-8119-00144feab7de.html#axzz3CHQbMKxU*. Beginning in October 2013 after the SEF rules compliance date, European dealers began to trade exclusively with other European counterparties in the market for euro IRS and dramatically moved away from trading with U.S. counterparties. Since October 2013, 91 percent of euro IRS trades take place between two European counterparties, while only nine percent occur between a U.S. and a European dealer. By May 2014, 94 percent of euro IRS trades were between two European counterparties, while only six percent of euro IRS trades were between a European and U.S. counterparty. Compare these figures to those from a month before the SEF rules' compliance date, when 71 percent of euro IRS trades were between two European counterparties and 29 percent between a U.S. and European dealer. This has been a clear shift in trading behavior for European dealers. This observation is also supported by an ISDA survey wherein 68 percent of non-U.S. market participant respondents indicated that they have reduced or ceased trading with U.S. persons. ISDA Update.

[121] ISDA Update.

[122] *Id.*

[123] Douglas A. Irwin, *Peddling Protectionism: Smoot-Hawley and the Great Depression* at 89–91 (Princeton University Press 2011).

[124] *Id.* at 18–23.

[125] *Id.* at 145.

[126] *Id.* at 142–143.

[127] *Id.* at 218.

[128] *Id.* at 152.

[129] *Id.* at 183.

[130] *Id.*

The formation of European trading blocs failed to stem Europe's trade deterioration. Rather, this development worsened Europe's economic decline through the 1930s, culminating in a devastating World War and the annihilation of Europe's economy. This trade war was not fully reversed until the General Agreement on Tariffs and Trade a decade later.

E. Return to the Spirit of the Pittsburgh Accords

The EC and CFTC must develop a cross-border regulatory relationship in the spirit of the Pittsburgh G20 accords. This relationship is necessary to avoid a trade war in financial markets akin to that which worsened the Great Depression.

A trade war over swaps market clearing and execution will be harmful for the U.S. As the world's largest economy and largest debtor, the U.S. must retain deep and liquid capital markets if it is to maintain its reserve currency status and its standard of living. Unfortunately, fragmentation of global swaps markets between U.S. persons and non-U.S. persons means smaller and disconnected liquidity pools and less efficient and more volatile pricing for market participants and their end-user customers. It also means greater risk of market failure in the event of economic crisis. By Balkanizing global swaps liquidity, the CFTC's Interpretive Guidance is actually increasing the systemic risk that it was predicated on reducing. Like Smoot-Hawley, the CFTC's Interpretive Guidance is ill-suited to its ostensible purpose of systemic risk reduction. It is, however, wreaking havoc and forcing U.S. financial institutions to retreat from what were once global markets. We simply cannot allow uncoordinated regulatory reforms to permanently divide global swaps markets between U.S. and non-U.S. persons.

Similarly, a trade war in swaps markets will be a disaster for Europe. The EU has a serious growth problem. Except for Japan, the EU has had the weakest economic growth in the industrialized world.[131] In the words of Francois Heisboug, "The world is advancing, but not Europe." [132] European Central Bank President Mario Draghi has highlighted that EU Governments need to implement structural reforms to increase sustainable growth and encourage investment in the euro zone.[133] Mr. Draghi's warning may be of little help if the debate over clearing equivalence remains unresolved, hampering business access to liquid markets for hedging of investment risk.

Undeniably, the EU is in desperate need of investment in economic development and job creation. European investment capital comes overwhelmingly from banks. European banks are significant participants in the U.S. derivatives markets, and the EU banks cannot afford to retreat from those markets.

Moreover, the process of bank deleveraging and overstretching of national governments mean that Europe must look to a broader array of financing sources available in modern global financial systems, including private lending, securitized credit and private equity. To avail itself of these options, the EU must assure U.S. capital access to European risk-hedging markets. According to CFTC data, trading volume on European futures exchanges relies to a considerable extent on direct access from the U.S. EU markets cannot afford to jeopardize this U.S. trading volume. Denying equivalence to U.S. CCPs will not cure Europe's stagnant economic growth—it will worsen it.

We must not let the current cross-border impasse over swaps markets persist and thwart European growth and, in turn, lead Europeans to conclude that the EU is not part of the solution but part of the problem.

Flourishing capital markets are the answer to U.S. and European 21st century economic woes, not trade wars and protectionism. The solution to sluggish growth in the developed economies is safe, sound and vibrant global markets for investment and risk management. We must maintain liquid and broad global derivatives markets. To do so, we must reach an accord on how to regulate derivatives execution and clearing in a harmonious manner across jurisdictions.

The CFTC is continuing its dialogue with the Europeans to facilitate their recognition of our clearinghouses as equivalent. Work continues on both sides to establish a sound and practical basis for regulatory and supervisory cooperation. As both sides work through differences to find common—and solid—ground, it remains critically important to provide certainty to CCPs and market participants to prevent any potential disruption to their businesses.

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[131] Francois Heisbourg, *La Fin du Reve Europeen (the End of the European Dream)* (Editions Stock 2013).

[132] *Id.*

[133] Todd Buell and Paul Hannon, *Eurozone Growth Drivers Were Broad Based, Data Show,* WALL STREET JOURNAL (Mar. 6, 2015), available at *http://www.wsj.com/articles/german-industrial-production-increased-in-january-1425631587?KEYWORDS=european+economic+growth*.

But we can go further. The CFTC must replace its cross-border Interpretive Guidance with a formal rulemaking that recognizes outcomes-based substituted compliance for competent non-U.S. regulatory regimes. I support the withdrawal of the CFTC staff's November 2013 Advisory that fails not only the letter and spirit of the "Path Forward," but also contradicts the conceptual underpinnings of the CFTC's Interpretive Guidance.

V. CFTC Resources and Budget

I want to thank Congress for the increase to the CFTC's budget for FY 2015. In fact, as Chairman Aderholt noted at the CFTC FY 2016 Budget Hearing in February of this year, the CFTC's spending has increased 123 percent since the Financial Crisis of 2008.[134] This significant increase is all the more appreciated given the nation's substantial debt. I realize the challenges Congress faces in allocating scare resources among agencies seeking increased funding to support their missions. I also realize that the CFTC must make a compelling case, and efficiently utilize existing resources, in order to justify further increases.

In this regard, the CFTC could be doing more. For example, managing the CFTC's flawed swaps trading regulatory framework is expensive and time-consuming. Fitting the square peg of the CFTC's swaps trading rules into the round hole of the established global swaps markets requires the Commission and staff to devote enormous resources to continuously explain, clarify, adjust, exempt and manipulate rules to allow rough swaps market operability. The Commission and staff must constantly add to the plethora of no-action letters, guidance, staff advisories and other written communications that go out to the market and participants. During the course of implementing the Dodd-Frank Act, the CFTC staff has issued 357 such communications.[135] The CFTC's current swaps trading regulatory framework requires enormous bureaucratic "make work" to assure industry compliance. Yet, it is mostly unnecessary and unsupported by Title VII of the Dodd-Frank Act. It wastes taxpayer dollars at a time when the CFTC is seeking additional resources from Congress.

Similarly, the CFTC's proposed position limits rules are overly burdensome and will require substantial agency resources to implement and sustain. They do nothing to leverage the decades of experience and large existing staffing capabilities of the major U.S. DCMs. Instead, the CFTC's proposed position limits rules would partially duplicate—at U.S. taxpayer expense—the management of position limits already being done by DCMs at industry expense.

The CFTC should work to reduce these and other examples of inefficiencies before asking for substantial budget increases. I will work to make sure that the CFTC is using its resources wisely. However, let me be clear. These comments are not meant to criticize the CFTC staff. The CFTC has a dedicated, professional staff who have been working hard to implement the Dodd-Frank Act and carry out the agency's existing responsibilities. The CFTC is fortunate to have such a staff to fulfill the agency's mission in service to the American public.

Conclusion

The CFTC has accomplished much since the passage of the Dodd-Frank Act, but many challenges remain. The CFTC must do more to reduce the regulatory burdens on end-users. The CFTC must make sure that our rules do not treat end-users as though they were the cause of the financial crisis. The CFTC must revisit its swaps trading rules and fully align them with the clear provisions of Title VII of the Dodd-Frank Act. Not doing so will continue to drive away market participants, harming swaps market liquidity and increasing market fragility. Finally, the CFTC and foreign regulators must redouble their efforts to cooperate and harmonize their regulations to preserve the global market for swaps trading. Without such efforts, market fragmentation will continue and systemic risk will increase, hurting global markets and growth.

Thank you for the opportunity to testify. I would be happy to answer any questions you may have.

The CHAIRMAN. Commissioner Wetjen.

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[134] Opening Statement of Chairman Robert Aderholt, House Committee on Appropriations, Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies, Fiscal Year 2016 Budget Hearing—Commodity Futures Trading Commission, Feb. 11, 2015, available at *http://docs.house.gov/meetings/AP/AP01/20150211/102910/HHRG-114-AP01-20150211-SD001.pdf.*

[135] As of April 9, 2015, the CFTC staff has issued 258 no-action letters, 56 exemptive letters and 43 staff interpretive letters, guidance, advisories and other written communications.

STATEMENT OF HON. MARK P. WETJEN, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. WETJEN. Good morning, Chairman Scott, Ranking Member Scott, Chairman Conaway, and Members of the Subcommittee. Thank you for inviting me to testify before you today, and allowing me to share some of my thoughts on the reauthorization of the Commodity Futures Trading Commission. It is a pleasure to be here.

I would like to acknowledge my colleagues and friends sitting beside me; Commissioner Bowen and Commissioner Giancarlo. Both have spent much of their careers working in the financial markets in some capacity, and so have brought significant expertise and professionalism to the Commission, which benefits not only the Commission's work but the public as well. It is an honor to serve with them.

I also want to acknowledge Chairman Massad for his continued pursuit of an agenda dedicated to further implementation of, and refinements to, Dodd-Frank. He has led the Commission in an admirable way, and has achieved consensus through his engagement of the Commission's policymaking and enforcement missions. I also appreciate this Subcommittee's constructive and collaborative relationship with the Commission.

The swaps and futures markets in the U.S. look considerably different today than they did in 2011, when I joined the Commission. Today, there are more than 100 swap dealers provisionally registered with the CFTC, clearing mandates in place for liquid swaps, and trading mandates requiring liquid swaps to be executed on registered exchanges, or SEFs. There also are new reporting obligations for market participants. Additionally, registered clearinghouses must meet heightened risk management requirements, and customer funds held by clearing members enjoy greater protections. The sum of these component rules and requirements is a safer and more transparent market structure for derivatives in the U.S. But there remains more work to be done, including three key rulemakings to implement Dodd-Frank; the rulemaking on margin requirements for uncleared swaps, the rulemaking on capital requirements related to uncleared swaps, and the rulemaking on Federal position limits.

My written testimony goes into detail about a variety of other initiatives the Commission should undertake to continue and improve its implementation efforts. It also identifies developing trends in the derivatives markets that this Committee should monitor in its oversight capacity. I will briefly summarize some of the key points.

Regarding cross-border initiatives, the Commission should clarify how it views the use of U.S. personnel by registered dealers otherwise located outside the U.S., and should use its authority to create a foreign SEF regime. These steps would address challenges created by the Commission's first mover impact as it has implemented reforms, especially the swap trading mandate. The Commission also should take steps to promote the trading of swaps on SEFs. These steps should include revising the conditions for eligibility under the floor trader exemption, clarifying that anonymous trad-

ing protocols on SEFs must remain anonymous post-execution, clarifying the application of the embargo rule as it relates to work-up trading sessions on SEF, and revising the process for imposing a trading mandate for swaps. Importantly, the Commission also must promptly approve SEF requests to offer appropriate execution methods different from those expressly permitted in the SEF rule. Regarding FCM risk management, the Commission should clarify how FCMs may screen block trades that are executed on or pursuant to the rules of SEFs.

All of these steps the Commission could undertake with existing authority. If accomplished, these steps would lead to an even safer and simplified market structure. The Congress could assist the Commission in two important ways through the reauthorization process. First, although outside the specific jurisdiction of this Subcommittee, the Congress should consider amendments to the Bankruptcy Code to allow the protection of individually segregated margin accounts of customers. This would enhance both customer protections and choice that would benefit end-users. Second, the Congress should revise the indemnification provision related to the use of data kept at swap data repositories. The current law has imputed data sharing and harmonization efforts at both the domestic and international levels. Finally, there are several developing trends this Subcommittee should monitor because they could provoke future policymaking responses. In no particular order, they are, regulatory market fragmentation, public distributed ledger technologies, FCM concentration, clearinghouse risk controls, automated trading systems, and cybersecurity. I am happy to elaborate further on these topics.

Thank you again for inviting me, and I look forward to questions.

[The prepared statement of Mr. Wetjen follows:]

PREPARED STATEMENT OF HON. MARK P. WETJEN, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Good morning, Chairman Scott, Ranking Member Scott, and Members of the Subcommittee. I would like to thank you for inviting me to appear before the Subcommittee this morning and allowing me to share some of my thoughts on the reauthorization of the U.S. Commodity Futures Trading Commission (CFTC). It is a pleasure to be here today.

Reauthorization provides Congress an opportunity to reflect on the work of the Commission and determine legislative solutions to any identified inadequacies. I appreciate the Subcommittee's efforts to approach reauthorization thoughtfully by listening to all stakeholders, such as in the Subcommittee's hearing with end-users on March 24 and with market participants on March 25, as well as in today's hearing.

Since I joined the Commission in 2011, the agency has largely completed its rulemakings under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which includes registering swap dealers and major swap participants, implementing the Commission's clearing and trading mandates for swaps, and setting up a regulatory-reporting regime for swaps. We now have more than 100 swap dealers provisionally registered with the CFTC, clearing mandates in place for liquid swaps and trading mandates requiring liquid swaps to be executed on designated contract markets (DCMs) or one of the more than 20 newly provisionally registered swap execution facilities (SEFs), as well as new reporting obligations for market participants. Additionally, the agency has strengthened the risk-management practices of registered clearinghouses, enhanced protections of customer funds held by futures commission merchants (FCMs), and issued a concept release addressing risk-management enhancements for automated trading systems and the firms that deploy them. Compliance with most of these rules has begun in full.

Since the beginning of 2014, as the Commission has continued its efforts to implement the new swaps market structure under Dodd-Frank and harmonize those efforts internationally, it also began to focus on revisiting policies that had an unintended impact on the end-user community of derivatives-market participants. The Commission recognizes the importance of limiting costs to these end-users.

I commend Chairman Massad for his continued pursuit of this agenda. Under Chairman Massad's leadership, the Commission considered amendments to the so-called residual interest rule, which was adopted unanimously by the Commission, and is currently considering amendments to the 1.35 recordkeeping rule, the treatment of forwards with embedded volumetric optionality, and the treatment of trade options as defined under the Commodity Exchange Act (CEA).

The Commission also has enjoyed an increase in resources needed to accomplish its mission, for which the agency and its staff are grateful. This year the Commission requested $322 million to pursue its mission activities, an increase of $72 million over its current operating budget. These additional funds would allow the agency to improve its examinations of clearinghouses, FCMs, and swap dealers; deploy additional technology to perform surveillance of increasingly automated markets as well as rationalize data; and enforce the Commission's rules. Given the increase in scope of its responsibilities and the consequent risks of inadequate oversight of the complex and global derivatives markets, the Commission can, and would continue to, appropriately deploy future, additional funds and deliver a good return on the taxpayer investment.

I have organized my testimony today with the goal of offering a constructive viewpoint on where the Commission and the derivatives marketplace stand generally, and with respect to implementation of Dodd-Frank more specifically. Toward that end, my testimony will address multiple topic areas, including (1) key rules the Commission should promulgate to continue implementation of Dodd-Frank; (2) the cross-border implications of the Commission's rules (identifying several discreet issues in particular); (3) swap-trade execution; (4) clearing and FCM risk management; and (5) swap reporting and data. In each of these topical areas my testimony identifies whether Congressional action is needed to address insufficiencies in authority or clarity concerning Congressional intent, or whether Commission action is recommended (based on existing, adequate authority from Congress). Finally, this testimony identifies developing trends in the derivatives markets that the Committee should be aware of and monitor while serving in its role as an authorizing Committee of the CFTC.

1. Dodd-Frank Rulemakings Related to Uncleared Swaps and Federal Position Limits

There are three key rulemakings required under Dodd-Frank that the Commission should complete and finalize: the rulemaking on margin requirements for uncleared swaps; the rulemaking on capital requirements related to uncleared swaps; and the rulemaking on Federal position limits.

Rulemaking on Margin for Uncleared Swaps. Perhaps the most important remaining rulemaking is the Commission's margin rule. The new market infrastructure for swaps agreed to by the G20, and required under Dodd-Frank, mandates clearing for liquid swaps, and appropriate margin requirements for those swaps that are not cleared. Measured in notional volumes, the market for cleared swaps steadily has increased since 2008, but the uncleared swap market remains substantial and in need of appropriate risk-management safeguards. Margin is an essential tool to mitigate the default risk associated with uncleared swaps as well as the consequent systemic risk that may follow the default of a large market participant.

In September, the Commission re-proposed its rule on margin for uncleared swaps, working in close cooperation with relevant domestic and international regulators. Importantly, and consistent with Congressional intent, the proposal exempts commercial end-users from the margin requirements that apply to swap dealers and certain financial entities. The Commission should finalize the margin rule as quickly as possible to provide certainty on the requirements for one of the last component parts of the post-reform, swaps-market structure. In finalizing this rule, the Commission must continue to coordinate with regulators both in the United States and abroad. The importance of global harmonization cannot be overstated given the risk of regulatory arbitrage if material differences in margin requirements exist among major financial markets.

Rulemaking on Capital Requirements Related to Uncleared Swaps. The Commission should proceed soon with its rulemaking on capital requirements related to uncleared swaps. When the Commission first proposed capital requirements for certain swap dealers and major swap participants in 2011, it aligned the comment periods for the proposed capital and margin rules so that commenters would

"have the opportunity to review the proposed capital and margin rules together before the expiration of the comment periods for either proposed rule." This was done because to the extent that uncleared swaps are not fully margined, additional capital may be appropriate to address the resulting increased risk in the swaps marketplace. The Commission should continue to be mindful of this interaction in finalizing the capital rule and should ensure that it does not create improper incentives that may increase costs for end-users.

Rulemaking on Federal Position Limits. Following the vacating by a Federal district court of the original position-limits rule in 2012, a rule was re-proposed on December 12, 2013. The comment period to that proposal has been re-opened several times, and as of today, the CFTC has received over 500 comments. Mindful of the potential impact this rule could have on the public, last year the CFTC held a public roundtable and an Agricultural Advisory Committee meeting that addressed position limits, and in February the CFTC's Energy and Environmental Markets Advisory Committee held a public meeting to hear from commercial end-users and other participants in the energy markets on the subject.

As reflected in Dodd-Frank, Congress intended for the CFTC to apply Federal position limits on DCMs and SEFs. I note that Congress gave the agency broad authority to craft a position-limits rule that protects against excessive speculation without curtailing legitimate hedging activities, including certain types of anticipatory hedging. In finalizing a rule, the CFTC should consider the effect on commercial end-users, farmers, ranchers, and other participants who use our markets to hedge risk, and ensure that we provide the appropriate flexibility for granting *bona fide* hedge exemptions.

2. Cross-Border Implications of CFTC Rules

As mentioned, one of the most important tasks before the Commission is to continue assessing the cross-border impact of Title VII and consider ways to appropriately harmonize its implementation efforts with those of non-U.S. regulators. Along these lines, the following issue areas are particularly important for the Commission to be engaged in over the coming weeks and months.

Equivalency Decision for U.S. Clearinghouses by the European Union. The CFTC continues to negotiate with the European Commission and European Securities and Markets Authority on whether our clearinghouse regulatory framework should be deemed equivalent to the European Union's clearinghouse regulations. The European Union has extended the deadline for the determination to June 2015. Without an agreement, higher capital standards would apply to European banks that clear their trades through registered clearinghouses in the United States, which could disrupt the ability of European banks to use our markets. The CFTC continues to consult with European regulators to work through the remaining issues, and I commend Chairman Massad and Commission staff for their efforts. Considerable progress has been made and an equivalency decision should be made soon by the European Commission.

Staff Advisory on U.S. Personnel. On November 14, 2013, CFTC staff issued an advisory that would apply the Commission's transaction-level requirements under Dodd-Frank, such as mandatory SEF trading, to swaps between a non-U.S. swap dealer and its non-U.S. client where the non-U.S. swap dealer regularly uses personnel located in the United States to arrange, negotiate, or execute such swaps. The Commission had previously determined in its cross-border guidance that swaps between two non-U.S. persons that are not guaranteed by U.S. persons lack a sufficient nexus with U.S. commerce for the Commission's transaction-level requirements to apply. Shortly after the staff issued the advisory, the Commission requested comment from the public on its subject matter and the staff provided no-action relief delaying its applicability.

Now that the comment period has been closed for some time, the Commission should take action to clarify the matters discussed in the staff advisory. Commission action in this regard should be accompanied by an appropriate implementation period to permit the marketplace to come into compliance without undue cost or burden. The current no-action relief expires in September of this year, so the Commission must act promptly or otherwise provide adequate additional time for compliance upon formulating its policy.

QMTF and Foreign SEF Regime. In collaboration with the Commission's European colleagues, last year the Commission provided relief from registration for qualified swaps-trading venues in Europe (QMTFs). This relief applied to QMTFs that have sufficient pre- and post-trade price transparency requirements, and provide non-discriminatory access to market participants. QMTFs also have to meet certain regulatory requirements in their home jurisdictions. So far, no foreign trading venues have used the QMTF relief. The Commission should continue to work

with the Financial Conduct Authority in the United Kingdom and other global regulators to resolve any issues relating to the QMTF regime.

The Commission also should invoke its statutory authority and promulgate rules creating a permanent regime for non-U.S. swap-trading venues, under which entities from a variety of jurisdictions could request exemption. The Commission, however, also must carefully consider the impact of such action on its own SEF framework and standards in order to protect the swaps marketplace and preserve the competitive standing of SEFs. Both efforts would help address some of the regulatory fragmentation (discussed below) the swaps market has experienced since the Commission's SEF framework and trading mandate went into effect.

3. Swap-Trade Execution

In 2012, the Commission completed rules providing for the registration of SEFs, which are regulated trading platforms designed to provide pre-trade transparency, reduce risk, and improve pricing for the buy-side, commercial end-users, and other participants that use these markets to manage risk. On February 15, 2014, the Commission implemented the first trading mandate for cleared interest rate and credit default swaps in the U.S. derivatives market. As of the most recent data, over $7.7 trillion notional of interest rate and credit swaps were traded in 1 month on SEF platforms under the CFTC's oversight.

The requirement that certain swaps trade on SEFs or DCMs was a momentous change for a marketplace that previously traded largely on an over-the-counter basis. A great many users of swaps were required to connect to execution venues and execute their swaps pursuant to certain trading protocols for the first time. Additionally, there was much uncertainty regarding the applicability of the execution requirement to swaps that were executed as part of a package with other swaps, futures, or securities (*i.e.,* "package trades").

Complicating matters further, the United States was the first country in the world to impose a trading mandate for swaps. While U.S. persons have been trading the most liquid swaps—particularly those denominated in U.S. dollars—in a more highly regulated trading environment (*i.e.,* on provisionally registered SEFs), the rest of the globe continues to trade swaps bilaterally, or on trading venues that are subject to lesser regulatory requirements than SEFs. The G20 committed to reforms that would require swaps to trade on regulated venues where appropriate, so it is expected that eventually there will be comparable trading venues in other jurisdictions. No other country, however, has achieved that objective as of now (Japan expects to impose a swaps trading mandate by the fall of 2015, but the European Union is not expected to impose one before 2017).

This is an important context to the analysis of the Commission's SEF and trading-mandate rules, and largely explains why non-U.S. entities have demonstrated a preference for avoiding execution on SEFs. Because SEFs are regulated trading environments and serve as self-regulatory organizations (SROs) for their platforms, SEF participants incur costs and face compliance burdens not found in other jurisdictions. Unless commercially or legally compelled to do so, market participants largely have chosen to avoid subjecting themselves to these higher costs and increased compliance risks associated with SEFs.

Policymakers therefore should be careful not to draw the wrong conclusions from the fact that many non-U.S. persons have avoided trading on SEFs. Indeed, while subject to core principles and Commission rules, required to function as SROs, and required to provide specific trading protocols for their participants, SEFs nonetheless are designed to be, and are—relatively speaking—flexible trading platforms as compared to DCMs. For instance, SEFs can offer requests for quote (RFQs) and conduct work-up sessions, and can conduct RFQs and work-ups using voice methods. Independent brokers, moreover, can continue brokering trades for mandated swaps outside of the SEF environment so long as the trade is "crossed" against a SEF order book.

Notwithstanding this fact, there are a number of steps the Commission should take to further realize Congressional mandates to promote trading of swaps on SEFs as well as promote pre-trade price transparency, both of which appear in the text of Dodd-Frank. These steps are described below under the categories of (i) initiatives that would further promote the trading of swaps on SEFs, and (ii) initiatives that would provide needed clarity to the SEF market structure.

i. Initiatives That Would Promote the Trading of Swaps on SEFs

The following policies should increase trading volumes on SEFs.

Floor Trader Designation for Market Makers. When the Commission finalized its swap-dealer-registration rule, it provided that those trading entities that are registered as "floor traders" and meet a number of specified conditions under the

rule do not have to register as swap dealers. This exemption was designed to promote market-making activities by non-traditional liquidity providers for the purpose of promoting liquidity formation on SEFs, and recognized that swap-dealer registration was not necessary or appropriate when the trading activity of the floor trader was anonymous and cleared at a clearinghouse (thus avoiding a traditional dealer-customer relationship).

The conditions for the floor-trader exemption need to be revised to make compliance practicable while ensuring that floor traders do not pose an increased risk to the marketplace. This would encourage more liquidity provision by non-dealer market makers and even more automation in execution. There are important policy debates associated with increasingly automated execution, as mentioned below in the developing trends discussion of this testimony. Separate risk-management requirements for intermediaries and registered clearinghouses currently in place, as well as other future initiatives to appropriately register non-dealer liquidity providers, are designed to address concerns raised by this automation trend.

Name Give-Up. Due to post-trade affirmation services or the SEF's rules, there are instances where counterparty identities are revealed after trades are executed on SEFs through an anonymous order book trading protocol. The Commission should require that trades that start anonymously on an order book must remain anonymous post-trade. This will promote a more competitive, transparent, and liquid swaps market. On April 2, 1015, Commissioner Bowen hosted a meeting of the Market Risk Advisory Committee where this issue was discussed, and the consensus of the participants was that the Commission should take action to end this practice through Commission guidance or rulemaking.

Embargo Rule—Work Ups. The embargo rule in part 43 of the Commission's real-time public reporting rules may impair a SEF's ability to generate liquidity during a work-up session. Immediately after an order or RFQ is executed, a SEF can conduct a work-up session, whereby a SEF's participants buy or sell additional quantities of the executed swap at the same price. These sessions can start and end within seconds or minutes, and can be a significant source of swaps-trading volume on SEFs.

The embargo rule prohibits the disclosure of swap transaction and pricing data to a SEF's market participants prior to the transmission of the data by the SEF to a swap data repository (SDR). Before the data is sent to the SDR, it needs to be enriched and converted. The embargo rule introduces latency into the work-up process by making the SEF wait until each order that results during a work-up is transmitted to the SDR before another work-up order can take place. SEFs conducting work-ups have expressed concerns about liquidity generation with the application of the embargo rule to work-ups. In addition, the time delay can frustrate the ability of market participants to trade at the price agreed to through the work-up session. Providing relief from the embargo rule for work-up sessions would promote more liquidity on SEFs, something the Commission could do under existing authority.

ii. Initiatives That Would Provide Clarity Around the SEF Market Structure

The following actions would address uncertainties caused by Commission rules concerning the current SEF market structure, and could minimize legal and compliance concerns that frustrate participation on SEFs.

MAT Determinations. The Commission should replace the current "made available to trade" (MAT) process with a Commission-initiated process that identifies the swap instruments subject to the mandate. Under the existing process, a single SEF's commercial interests in mandating (or not mandating) a swap dictates whether the Commission will review a proposed mandate. This is not the best approach to make policy decisions for the entire market. A Commission-initiated determination would be more orderly and would eliminate many questions around the scope of a mandate—including its applications to package trades (see below)—by including a traditional comment period process. No additional authority is needed by the Commission to pursue this policy change.

Package Trades. Commission staff provided relief from the trading requirement for package trades on May 1, 2014, and subsequently held a public roundtable to identify practical and jurisdictional concerns that affect their trading on SEFs. Having heard from the public on the issue, the staff set forth a phased compliance approach that has since brought package trades involving all MAT legs, and MAT legs with non-MAT cleared legs, onto SEFs with minimal disruption to the marketplace. On November 10, 2014, staff granted further relief for SEFs for package trades with futures legs until November 2015, and for more complex package trades (*e.g.,* transactions that include MAT legs with uncleared swaps, a non-swap instrument, or se-

curity-based swap legs) until February 2016, to be executed by any means of execution.

The Commission should consider whether to formalize making some of this temporary relief permanent in order to provide more certainty and flexibility for these transactions. In the meantime, the Commission will continue to examine how the market has reacted to the expiration of previous package-trade relief.

Block Trades. The Commission's requirement that a block trade "occurs away" from the SEF has created additional complexity for trading large transactions, and executing block trades away from the SEF has presented difficulties for SEFs and FCMs to conduct the required pre-execution, credit-check screenings. The Commission should similarly consider whether to make permanent the existing no-action relief that allows executing block trades on or pursuant to a SEF's rules, which expires at the end of this year, or clarify other ways for market participants to execute block trades.

Error Trades. Some swap trades are rejected by a clearinghouse because of operational or clerical errors made by market participants or SEFs. While these operational and clerical errors otherwise would be easily corrected, due to certain Commission rules the trades are rejected from clearing. Relatedly, because trades are required to be submitted for clearing immediately after execution, counterparties may not have an opportunity to attempt to correct an error until after the transaction has cleared. Re-submitting these same trades again correctly could conflict with the CFTC's rules against pre-arranged trading. The Commission has been granting and extending no-action relief since 2013 to address these issues.

SEFs should be permitted to determine whether there are actual errors, and to correct such errors, or to execute an offsetting or pre-arranged swap that reflects the correct parties and terms. The policy goals of submitting trades immediately for clearing are obviously important, but in some instances they should be balanced against the goals of fixing errors and allowing counterparties who want to maintain the swap to do so. Although the Commission has been responsive by granting no-action relief, in order to provide certainty to the market and participants, the Commission should consider revising our rules to find a more lasting solution.

Financial Resources. SEF Core Principle 13 requires a SEF to have financial resources in an amount that exceeds the total amount that would enable the SEF to cover the operating costs of the SEF for a 1 year period, as calculated on a rolling basis. As we have become more familiar with the role of SEFs, it has become clearer that unlike other registered entities, SEFs do not hold or carry the risks of positions and trades executed on it, and do not own the products traded on them (*i.e.,* swaps are fungible and can be traded on other SEFs). As such, a SEF does not need as much time or capital to wind-down as a DCM or clearinghouse. In addition, this core principle disproportionately affects SEFs that offer voice-based execution methods as compared to purely electronic SEFs.

In light of these facts, Congress could consider reducing the 1 year period to provide more flexibility to SEFs. In the meantime, the Commission should consider whether there are ways to interpret this core principle and revise its regulations to provide a more reasonable and execution-method-neutral way for SEFs to comply. One such way to do so would be to re-consider commenters' requests to interpret operating costs to mean the costs of an orderly wind-down.

4. Clearing and FCM Risk Management

A hallmark of Dodd-Frank is the clearing mandate for liquid swaps. A cleared marketplace relies on clearinghouses as well as FCMs to manage risks associated with positions taken by participants. To improve this market structure further and minimize risks to customers in particular, the following steps should be considered.

Individual Segregation. Customers and end-users have repeatedly approached the Commission seeking greater protection for their funds in the event their FCM becomes insolvent. These concerns have been amplified by the failures of MF Global and Peregrine, and by the market impact of the Swiss central bank's decision to abolish its 3 year old policy of capping the Swiss franc against the euro. The Commission has spent considerable resources enhancing protections for customer funds, but there is more that could be done.

Currently, section 766(h) of the U.S. Bankruptcy Code continues to subject customers to mutualized risk by requiring that customer property be distributed "ratably to customers on the basis and to the extent of such customers' allowed net equity claims." With respect to cleared swaps, this requirement limits the Commission's flexibility in designing a model for the protection of customer funds that allows for individual segregation. This means that even if a customer's funds are held in a completely separate account from the funds of other customers, if the cus-

tomer's FCM becomes insolvent and there is a shortfall in the FCM's customer omnibus account that customer only will get back his or her *pro rata* share.

For customers who believe they can better protect their funds in the OTC marketplace, this potential result is unsatisfactory. It would aid the Commission's work if Congress were to amend the Bankruptcy Code to permit greater flexibility with respect to the protection of customer funds.

Futures Commission Merchant Risk Management. Regulation 1.73(a)(2) provides that an FCM must screen trades against its risk-based limits. The method and timing of the FCM's screening obligation, however, is dependent upon the nature of the trade, recognizing that not all types of screens are possible on certain types of transaction. As discussed above, there exists in the marketplace some uncertainty with respect to how [rule] 1.73 applies to block trades. The Commission should address this uncertainty and clarify how the FCMs can comply with rule 1.73 with respect to block trades.

5. Swap Reporting and Data

The following steps should be considered to improve the Commission's swap-reporting regime.

Rulemaking on Reporting of Cleared Swaps. Dodd-Frank added to the CEA section 2(a)(13)(G), which requires all swaps—whether cleared or uncleared—to be reported to SDRs. Notwithstanding the harmonization effort between the CFTC and the SDRs to make swap data more consistent, and therefore more usable for regulatory purposes, there remain challenges to the usability of the cleared-swap data being reported. For example, reporting of cleared swaps is complicated by the so-called alpha swap being reported to one SDR, and the beta and gamma swaps being reported to another SDR. Alpha swaps remain open in SDR data and appear to be bilateral, but are in fact subject to the clearing requirement.

The result is that swaps that appear to be subject to the clearing requirement are appearing in the SDR as bilateral, uncleared "open swaps", when in fact they have been accepted for clearing by a clearinghouse. This outcome impedes the Commission's ability to quickly and accurately review compliance with the clearing and trade-execution requirements, assess the size and scope of a given product's market, and assess the impact of uncleared swaps trades on the risk profile of clearing members and their customers. Staff is preparing a recommendation to the Commission on how to address this matter, and the Commission should act on that recommendation as soon as practicable.

Indemnification Provision related to Swap Data Repositories. As indicated, Dodd-Frank required that all swaps be reported to SDRs. Separately, CEA section 21 requires SDRs to make data available to certain domestic and foreign regulators so long as they have agreed in writing to abide by specified confidentiality requirements, and to indemnify the SDR and the Commission for any expenses arising from litigation relating to the delivered data or information. In 2012, the Commission issued guidance that clarified that the confidentiality and indemnification provisions do not apply to a registered SDR if it also is registered (or otherwise authorized) in a foreign jurisdiction, and the data sought to be accessed by the foreign regulator had been reported to the registered SDR pursuant to the foreign jurisdiction's rules. Notwithstanding this helpful interpretation, issues remain.

First, other U.S. regulators may need access to this information to fulfill their responsibilities and mandates, but they would be prohibited from obtaining the information from an SDR without executing an indemnification agreement. Second, these requirements continue to cause concern among foreign regulators, some of which have expressed unwillingness to register or recognize an SDR unless they have access to necessary information. The CFTC continues to work toward ensuring that both domestic and international regulators have access to swap data to support their regulatory mandates. But it would be useful to the Commission's regulatory mission if Congress were to revise the CEA to remove the indemnification requirement from these information sharing provisions.

6. Developing Trends in the Global Derivatives Markets

Finally, the Committee should be aware of the following developments, as they could re-shape the derivatives markets and potentially provoke future policy responses from the Congress and the Commission.

Liquidity Fragmentation in the Global Swaps Markets. As indicated in the discussion above on SEFs, today, some swap-trading decisions are being made to comply with or avoid rules and mandates imposed by law, and are no longer driven solely by the liquidity profile of, or expertise in, a given marketplace. Consequently, separate pools of liquidity have formed in distinct parts of the world largely based

upon the legal status of counterparties. To be sure, differences in the timing and content of global reforms are part of the reason, as mentioned.

Avoiding fragmentation is desirable because (i) consolidated liquidity pools translate to reduced costs for end-users through tighter bid-ask spreads and improvements to other market-quality factors; (ii) centralized liquidity not only increases transparency for the broadest cross-section of price-takers, but reduces informational and trading advantages that accrue only to those able to navigate the complexities of a fragmented market structure; and (iii) from a systemic-risk standpoint, fragmentation can lead to increased operational risks as entities react to and structure around the rules. The steps identified in the cross-border section of this testimony could make significant strides towards limiting market fragmentation.

Apart from those refinements to existing Commission policy, a revamp of the Commission's overall cross-border guidance for swaps is not necessary at this time. The better policymaking course would include waiting until more of the other G20 nations with significant swap markets—namely, the European Union, Japan, Canada and Australia—implement their clearing and trading mandates pursuant to their respective reforms, and then analyze how those reforms compare as well as their market impacts. Only then will U.S. policymakers be able to make informed and thoughtful decisions about additional steps they should take.

Disruptive Technologies. Some relatively recent technological advancements have the potential to further reduce risk in our markets if those technologies become more widely embraced. Bitcoin-like protocols or distributed public ledger technologies could provide and enhance various settlement and other trustee-like services provided by registered entities in the derivatives markets, where monies and collateral are frequently transferred and settled throughout a trading day. These technologies work to provide a record of transactions and changes of ownership, and can be used to validate any type of transaction—including the more familiar concept of exchanging cash or currencies, as well as other types of assets or collateral, such as stocks, bonds, and securities. With these technologies, this can be done without the use of banks or other intermediaries.

Whereas now settlement may take days or occur intra-day depending on the market, this technology potentially could be used to facilitate settlement close to, or in, real-time. Reducing the time for transfers and the need to use an intermediary in the settlement process could further reduce risk to end-users and other market participants. This technology, moreover, has the potential to be used to display transaction information in close to real-time, and to maintain records of those transactions.

These are just a few of the obvious use cases for this technology, which, if deployed in Commission-regulated markets, would present new policy questions for the agency and this Committee. These questions include, among others, how new technologies will challenge or fit into current regulatory frameworks, potential regulatory barriers for new technologies, the impact on incumbents, and whether their use necessitates additional customer protections. Both the Commission and this Committee should continue to think about these questions and challenges. The Subcommittee also might consider directing the Commission to undertake a study to examine how these technologies could assist with compliance or otherwise reduce risk in the markets it oversees.

FCM Concentration. Policymakers should continue monitoring the number of FCMs actively involved in the derivatives markets as time continues. The number of registered FCMs has decreased since the financial crisis, which may make it more difficult for customers to manage their risk by limiting their ability to access the markets, or by making it more difficult for them to allocate funds among multiple FCMs to minimize concentration risk.

The overall framework of regulatory requirements that registered FCMs must comply with is substantially different today than it was before the crisis. FCMs are now subject to an enhanced customer-protection framework enforced by the Commission, with the result that the risks posed to customers funds stewarded by FCMs have been significantly reduced. This is a positive development.

During this same timeframe, the prudential regulators have enhanced their capital requirements for global financial institutions, resulting in more capital being held by FCMs that are affiliated with a bank holding company. While the Commission's and Prudential Regulators' measures are intended to safeguard the markets in times of stress, the consequences resulting from the costs associated with this framework remain to be seen. For instance, clearinghouses and FCMs have begun more serious discussions about facilitating more self-clearing arrangements for customers, a development that could raise a host of policy issues and considerations. Meanwhile, there are more reports in the media of additional fees being imposed on customers by FCMs resulting from the new capital-requirements framework.

This Committee should monitor these developments and could play a role in ensuring that market regulators such as the CFTC on the one hand, and prudential supervisors on the other—which separately enforce different types of regulatory regimes with different policy objectives—do not pursue goals that are at cross purposes with each other. The G20, and subsequently the U.S. Congress and regulatory community, agreed to reforms that (i) promote the clearing of derivatives, as well as (ii) raise capital standards for global banks. Policymakers should take care to avoid unnecessarily thwarting the former in pursuit of the latter. It also is worth pointing out, however, that if market regulators and prudential supervisors pursue conflicting agendas as it relates to clearing, it could further incentivize the deployment of novel legal and technological solutions to compliance.

Central Counterparty Risk. Clearinghouses play an increasingly important role in the wake of implementation of G20 financial reforms related to the clearing of derivatives contracts. Consequently, the CFTC has been hard at work putting in place a framework for effective oversight and regulation of clearinghouses. Nonetheless, it is appropriate that at this stage of the overall financial-reform effort, regulators and the Congress consider what, if any, additional measures should be taken.

Additional authority from Congress is not needed for the Commission to responsibly undertake this process of review. The areas related to clearinghouse risk management worth analyzing include: enhancing transparency with respect to clearinghouse stress tests, and reviewing how much of a clearinghouse's own capital—and under what circumstances—should become part of their plans for determining who pays in the case of a major clearing member default. Market regulators such as the CFTC also should assess clearinghouses' recovery and wind-down plans, and, to the extent a settlement or custodian bank failure impacts the ability of a clearing member (or group of clearing members) to timely meet its payment obligations to a clearinghouse, the ability of a clearinghouse to timely meet its payment obligations to its clearing members.

Cybersecurity. DCMs, SEFs, SDRs, and clearinghouses are required by the CEA and Commission regulations to establish and maintain "system safeguards," which include, among other things, a program to identify and minimize sources of operational risk, emergency procedures, backup facilities, a business continuity and disaster recovery (BCDR) plan, and to conduct periodic BCDR plan testing. These entities are also required to promptly notify Commission staff of certain cyber security incidents or targeted threats. Commission staff conducts systems safeguards testing that examines whether these standards are being adhered to; however, staff does not conduct independent testing. Other registered entities are also required to have BCDR plans and periodically test them.

Commission staff recently conducted a public roundtable on cybersecurity and system safeguards testing in March where we heard from registered entities, market participants, and other government agencies that have developed best practices. End-users and participants rely on our markets to hedge their risks, and any disruption by way of a cyberattack could have an adverse effect on those users, such as the theft of personal information or a market disruption or outage.

The Commission is considering potential enhancements to our systems safeguards rules and testing to further strengthen the security and resilience of our markets to cyberattacks. As part of this effort the Commission should evaluate what types of system safeguards or testing are appropriate for other registered entities. In addition, the Commission can consider changes to the current rules, such as making the notifications to the Commission of cyberattacks confidential, in order to foster transparent and prompt disclosure to the Commission. Finally, the Commission should assess whether entities that provide services to our registered entities, such as the National Futures Association, or third-party vendors like Markit, should be subject to systems safeguards rules or testing.

In addition to making changes to our rules, in order to develop and test more effective cybersecurity and systems safeguards, it is critical to have the participation of all interested parties—financial regulators, the private sector, and the intelligence/law enforcement community. We should be considering innovative ways to foster this testing and participation, such as the voluntary CBEST program conducted by the Bank of England which brings regulators and the intelligence/law enforcement community together to assess cybersecurity risks to the financial system.

Automated Trading. Automated trading systems are becoming more omnipresent in the derivatives markets, and are often used by both traditional and non-traditional liquidity-providing firms. Automated trading can sometimes be seen in a negative light, but there are academic studies that support the views that such trading can be detrimental to a market, or benefit liquidity, or both. For example, a recent report on the rapid Swiss franc currency swings highlighted how automated trading might have contributed to sharp price movements, but also enabled the mar-

ket to stabilize faster than otherwise expected. As the trend towards automated trading continues, and especially if the Commission encourages it by adopting policies that facilitate the use of automated systems in swap execution, the Commission must be vigilant in ensuring those systems have adequate risk controls, and operate in an appropriate regulatory framework to enable the Commission to achieve its overall mission.

On September 12, 2013, the Commission published a *Concept Release on Risk Controls and Systems Safeguards for Automated Trading Environments.* The Commission is considering the next steps for regulatory action in this area with respect to pre-trade risk controls, post-trade measures, and other protections to reduce the risks arising from a malfunctioning automated trading system, and to promote the safety and transparency of automated-trading environments. To pursue these measures, the Commission sought comment on the role of a registration requirement for firms that deploy automated trading systems. Recently, the U.S. Securities and Exchange Commission took a similar approach and proposed a rule that requires such firms operating in the equities markets to become members of the Financial Industry Regulatory Authority.

Thank you again for inviting me today. I would be happy to answer any questions from the panel.

The CHAIRMAN. Thank you, Commissioners. And I would like to remind the Members I would like to hold as closely as possible to the 5 minute rule, and then hopefully we will have a second round of questions.

I would like to start with a question about the swap dealer *de minimis* levels that I am sure you are familiar with, and we have heard numerous witnesses explain the uncertainty that they face with the current rule that automatically lowers the swap dealer *de minimis* level. Regardless of the results of the pending study on what the level should be, recently the Commission voted to undo a similar automatic change in the residual interest deadline. I would like to ask each of you, do you think it would be appropriate to also undo the automatic change in the swap dealer *de minimis* level and simply set it at $8 billion, unless the Commission votes to change that? It is for all of you.

Mr. WETJEN. Are we going in alphabetical order?

The CHAIRMAN. We will start with Commissioner Bowen.

Ms. BOWEN. Yes. I think it is important that we make sure that our rules are based upon good data, and at this stage, I have no basis upon which I would suggest that we change a rule that is already in effect. So at this stage, I would not think that would be wise for us to do so.

Mr. GIANCARLO. Chairman, under the prior Chairman of the CFTC, two rules were adopted. You referred to both of them; residual interest and the swap dealer *de minimis*. Both of those called for an automatic change in the standard in the year 2017, and both of those rules called for a study to be done, and in both cases they prescribed that whatever the outcome of the study, the rule would, nevertheless, change.

I disagree with that just as a matter of good regulatory practice. If we are going to go and spend the taxpayers' money to do a study, then we ought to take account of what the study says before we change our rule. That was the basis for which we, in September, changed the rule with regard to residual interest. What we said was we will read that study, and then if residual interest needs to—if there needs to be a change, we will make the change. At the same time, I also said we should approach it in the same way with regard to the *de minimis* levels for swap dealers. Right now, $8 bil-

lion and more is the qualification by which an entity is treated as a swap dealer. In 2017, that will automatically lower to a $3 billion threshold, regardless of what the study, that we are spending taxpayer money to do, says should be the right level. So I feel that we should not make an automatic change; we should read the study, and then if it is appropriate to change the *de minimis* level, we should do that.

The CHAIRMAN. Yes.

Mr. WETJEN. Mr. Chairman, I echo the comments made by my fellow Commissioners. I think the importance here is that whatever decision is made about what types of entities should be registered as dealers, there should be a data-based reason for it.

I actually think the way the rule is drafted now reflects that approach, but I am open to changing that approach as well. If a vote has to take place after a data analysis is done, I am perfectly comfortable with that.

As Commission Giancarlo alluded to, we just made a similar revision—well, as you alluded to, we just made a similar revision in the residual interest context, so I am open to it in the swap dealer *de minimis* context as well.

The CHAIRMAN. Well, thank you.

Last fall, there was an article on *Risk.net* regarding the use of special calls by the CFTC staff. The article noted that many farms were small, legitimate hedgers are facing increased scrutiny under the large trader reporting rule. This rule significantly lowered the amount of exposure and swaps contracts that would trigger a reporting requirement in some cases to as little as ¼ of the equivalent exposure in the comparable futures contract.

Commission Giancarlo, can you explain the process for deciding when special calls are issued, and what the internal process for overseeing them is, and have they ever been issued in error?

Mr. GIANCARLO. Thank you, Mr. Chairman. The special call process is a process used at the CFTC as part of its oversight authority, and part of its long-standing practice at the Commission. Special calls have a legitimate role in our work. I have become aware over the last few months of a large number of industry participants raising concerns about an expansion in the use of special calls, a fairly dramatic expansion, over the last several years. I am also aware that these special call letters contain in them some fairly serious statements about legal liability and responsiveness from which our market participants perceive to be fairly threatening.

It has also come to my attention that some time in the fall, several hundred special call letters were issued that had to be called back in the first quarter of this year, that they were issued in error. I am quite concerned that we have the right processes and procedures around our special call process, that there is appropriate oversight within the agency, and there is reporting up through the Commission as to how special calls are used. They do have a legitimate role, but we need to make sure that we as a Commission operate them, because it goes to our credibility as a Commission that we operate this process through proper procedures.

The CHAIRMAN. All right, thank you. My time has expired.

Mr. Scott.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman.

Let me start off by asking each of you, do you believe that we in the Congress are appropriating sufficient funds for you all to do the job that we are mandating you to do?

Ms. BOWEN. As I mention in my statement, it is critically important that we receive additional funds. Our role has expanded tremendously, and yet we have fewer employees today than we did before Dodd-Frank.

The markets that we are overseeing are quite complex, and the products that are there are really quite complex. So in order for us to really do our jobs as effective regulators, we really need to be able to have the resources to actually hire additional staff to make sure that our technology, frankly, is up-to-date. The market, as you know, moves at an extremely fast pace, and that is not likely to change.

Mr. DAVID SCOTT of Georgia. All right.

Ms. BOWEN. Likewise, as I mentioned, with cybersecurity being a growing threat, we need to make sure we have the resources to have protections in place.

Mr. DAVID SCOTT of Georgia. Thank you.

Mr. Giancarlo?

Mr. GIANCARLO. Thank you, Ranking Member. As a longstanding consistent supporter of the Dodd-Frank reforms, I believe we absolutely must have the resources to do a job that has been greatly expanded. However, I am also sensitive to the fact that our budget has increased 123 percent since 2008. I support the current funding levels, to the question of going above those levels really turns on whether, as you put it, the job we need to do. And I have some questions as to whether in some cases we are doing the job we need to do, or we are doing other jobs. I have, in my white paper, outlined ways in which our swaps transaction reforms are overly complex, do not accord with the Dodd-Frank reforms. I am also concerned that our position limits proposal creates an enormous amount of make-work for the Commission that could be done in other ways at less taxpayer expense.

So finding the right level of funding really is the key question.

Mr. DAVID SCOTT of Georgia. And, Mr. Wetjen?

Mr. WETJEN. Ranking Member, I do think we could use additional resources. The responsibilities of the agency have grown in three different respects. The size of the market we oversee is larger than it was before, the number of registered entities that we regulate has increased, and the amount of risk that registered entities have to manage has also meaningfully increased over the years. To reflect all of those key points, the resources of the agency have to come in line with that as well.

This isn't a scientific process. I don't think there is any special number; but, as I just explained, as the responsibilities have grown, the resources of the agency have to grow as well.

One last point on the number of registered entities. We have literally tens of thousands of registered entities. We have some help from the NFA in overseeing those entities. The most important entities are clearinghouses, in my judgment, to make sure that those are properly managed, given the amount of risk being managed by those entities at the moment, and we are just not doing a good

enough job, I don't believe, in examining them. There are several very important and large clearinghouses that we should be looking at and examining on an annual basis, and given the team that we have today, we are not able to do that.

Mr. DAVID SCOTT of Georgia. All right. Well, thank you very much. It has been very helpful.

Let me go back to you, Ms. Bowen, and you mentioned two important areas that concerned me; cybersecurity as well as the penalty enforcement level of wrongdoers. Could you elaborate for a minute on that? How do we get our hands around getting stronger enforcement penalties applicable for those within the financial service industry that do wrong and for those bad actors out there? What would be your proposal and how far could you go in terms of brining criminal actions where people could, if they do wrong, could serve time in jail because, unless we get to that and be able to nip it in the bud, being strong and give examples, we have MF Global, we have so many examples, how would you guide us in that direction?

Ms. BOWEN. Thank you for that question. First, we should have much higher penalties. Frankly, they are just way too low. And we have heard people refer to that as it is just the cost of doing business. So we are not conveying the right message to deter people.

The other thing that I would suggest is that, because the market that we oversee is so complex of so many bad actors, we need more people. We are the cop on the beat, so we can't afford not to have the sufficient staffing there in terms of our enforcement division. They have done a really good job. We have gotten some fairly large civil penalties over the last few years, and in some respects that signals the commitment and the dedication of our enforcement staff, but we need more of them to do the right thing and to make sure that our markets are safe. And, frankly, in the 10 months that I have been there, I have been, frankly, surprised at the number of Ponzi schemes and the attempts to take advantage of retirees, and——

Mr. DAVID SCOTT of Georgia. Yes.

Ms. BOWEN.—we need to make sure that the most vulnerable are really protected.

Mr. DAVIS SCOTT OF GEORGIA. Thank you very much.

I yield back, Mr. Chairman.

The CHAIRMAN. Chairman Conaway, you have 5 minutes, or as much time as you would like.

Mr. CONAWAY. I will endeavor to stay under the 5 minute rule, thank you.

Couple of years ago, we had European Commissioner, guy named Patrick Pearson, who was in front of us who was warning us about: if we didn't have regulatory harmonization, that firms would conduct and clear their trades and ward-off regulatory jurisdictions, which would regionalize markets and concentrate risks in different segments of the world. Two years hence, are we seeing Mr. Pearson's predictions come true, and then if so, what are the consequences? So why don't we start at the other end, Mark, and come this way this time.

Mr. WETJEN. Thank you, Mr. Chairman. I indicated in my written testimony, Mr. Chairman, that we have seen some regulatory

fragmentation since the CFTC has implemented its rules. I believe it is largely the result of this first mover impact I mentioned. There are some changes and revisions that we should make, as I have outlined, and there is considerable agreement among the Commissioners about some initiatives that we can and should take to simplify or refine or improve our rules, but I do think by and large, what we have seen has been a result of this first mover impact of the CFTC. And part of the reason I say that is our cross-border guidance, it was a risk-based policymaking. So we looked at risk and how it might be transferred back to the United States, but importantly, it relies very heavily on this notion of substituted compliance, and in order for it to work, in order to avoid what we have seen happen already, every jurisdiction needs to be open to and embrace a substituted compliance framework.

We actually have at the CFTC a pretty good record on this. We have found substituted compliance for six major non-U.S. jurisdictions where we have swap dealers registered, so in essence, we have said you must register because of the amount of U.S. business you are doing, but if you comply with your home rules, you are going to be compliant with ours. And that is just one example. There are many other examples of substituted compliance that we have already found as an agency. Going forward, we have to continue to do that, including on the trade execution front. I mentioned in my remarks how we need to put in place a foreign SEF regime. We already have a foreign board of trade regime. And those types of regimes are critical, again, to avoiding what we have seen. I wish we didn't have the situation that we are facing now, but again, it is largely due to the fact that we have largely completed our implementation effort today, and the other major swap jurisdictions have not.

Mr. GIANCARLO. Thank you for the question, Chairman Conaway.

Patrick Pearson's prediction has absolutely come true, and I must say he wasn't the only one to make that prediction 2 years ago. We are definitely seeing the conduct and clearing of trades being siloed into regional marketplaces, and unfortunately, we are seeing trading in a whole range of products flee U.S. shores. We have seen interest rates swaps outside of the dollar pairs move outside of the U.S. shores, we have seen it in certain sections of the credit default swaps market, and in other financial markets as well. This is not unprecedented, just a historical example that multitrillion dollar Euro-dollar market that takes place in London and in Asia should be a market that should be an onshore market, but Treasury regulations put in place in the 1970s drove that marketplace offshore, and when those regulations were lifted in the 1980s, those markets did not come back.

We have built a way—as I have said in my white paper—a way more over-engineered and overly complex swaps trading regime that is driving trading offshore. Interestingly, the Singapore authorities and the Hong Kong authorities have not put anything similar in place. They are sitting there hoping those markets will move in their direction, and they will benefit from it, and it will not only—we will lose that access to those markets, or at least direct access, all the jobs that will go with them as well. So I am very

concerned about what Patrick Pearson talked about, and I sadly have to say, it is coming true.

Mr. CONAWAY. Right. Go ahead, Ms. Bowen.

Ms. BOWEN. I think it is critically important for us to harmonize as best we can, and I agree with Commission Wetjen that part of it is a question of timing, and the fact that we were the first movers. But let's look at this in the context of a global market, which is the market we are regulating. We are trying to protect investors and to make sure that the risk that may occur outside of our borders doesn't flow back. And that means that we have to make sure that our standards are sufficient to protect our investors. At the same time, as you know, I support the Chairman's efforts. I think he is making some great progress with substitute compliance and equivalency, and we are moving in the right direction. But I would not suggest that we slow down our efforts by any stretch of the imagination.

Mr. CONAWAY. I yield back.

The CHAIRMAN. Thank you. Mr. Aguilar.

Mr. AGUILAR. Thank you, Mr. Chairman.

I had a question regarding SEFs. Commissioner Wetjen, you mentioned in your testimony some of the ideas that we could implement, and that the success of the SEFs is determined on the volume at these facilities. Can you expand on that, and I would love to hear what the other Commissioners feel we can do, specifically ideas to encourage increased volume?

Mr. WETJEN. Thank you, Congressman. There are two requirements of SEFs laid out in Dodd-Frank. The first is to promote trading on SEFs, and then the other is to promote pre-trade price transparency. So there is a dual mandate, as it were. And the SEF platform—rather, the SEF rule was designed to try and meet those two objectives. But at the heart of this is a Congressional intent, I believe, to make these platforms flexible. And to put that in a context, if Congress had wanted us to make them less flexible than they are, they could have said that all swaps must be traded on a futures exchange, and that is not what they did. So I agree with the other Commissioners that we do have a separate task here with SEFs. They are designed to be more flexible than other exchanges.

A couple of things would be helpful in terms of promoting trading, but also would have the effect of promoting pre-trade transparency, is bring additional liquidity providers onto the SEFs, and based on a couple of policies in place today, some of those liquidity providers are unwilling to trade on SEFs. So we should not have the same kinds of regulatory obligations for a trading firm that does not have customers, for example, and that uses automated trading systems to trade. We shouldn't have the same obligations for them as we do a swap dealer. That was the purpose behind the floor trader exemption. The conditions in place to take advantage of that exemption are too onerous, so they need to be revised.

That is really one of the key things we have to do. I also mentioned doing away with the name give-up of counterparties to trades when they are trading in a central limit order book. It sounds like a bunch of gobbledygook, but a central limit order book is supposed to be an all-to-all anonymous trading environment.

And the fact that some platforms are revealing the identities of some of the participants post-trade, again, discourages some market participants from wanting to trade there.

So again, it speaks to the willingness of people to come onboard these platforms and trade, and we need to make an adjustment there as well if we want to bring additional liquidity providers.

Mr. GIANCARLO. Thank you your question, Congressman. In 2014, in fact, for the last 5 years in a row, the United States' initial public offering market has led the world in IPOs. In fact, companies from all around the world have flocked to conduct their initial public offering on the U.S. Stock Exchange. In fact, the largest IPO in history took place last September when Alibaba listed its shares. Alibaba, a Chinese company, listed its shares on the New York Stock Exchange. Now, they did that despite the fact that the Hong Kong Exchange wooed them enormously to get them to list their offering there. The reason they listed in the United States is because we have the best rules for listing of initial offerings. Not the most lenient rules, not the most harsh rules, but the best rules. That should be our objective with regard to swaps trading as well. We should have the best regulatory regime in the world with the best protections, with the most clarity and, as Commissioner Wetjen said, the most flexibility. The same flexibility that Congress provided for in Title VII.

I believe if we could get our SEF rules right, we could lead the world in swaps trading, and that will be good for the United States of America.

In my written testimony, I have put forward several proposals where Congress can help in the area of our core principles. The core principles that were in Title VII were unfortunately lifted directly from the DCM, or Designated Contract Market, specifications for core principles. With some slight changes, we could get our core principles to work much better than they do. Changes in Core Principle 4 to margin of trading in underlying markets, Core Principle 6 of the SEF control of position limits, Core Principle 8, emergency authority for liquidation, and Core Principle 13 for financial resources. I don't want to take more time; I direct you to my written testimony for an explanation of those. Thank you very much.

Mr. AGUILAR. Thank you.

Ms. BOWEN. I am proud to be a sponsor of the newly formed Market Risk Advisory Committee. And, frankly, one of our meetings we had a couple of weeks ago, market structure and SEFs was one of the primary topics of that day. We have input from the market, we have input from academics, we have input from other stakeholders, and that is the kind of feedback that we need to make sure that we can make the proper decisions. And we are looking at things such as whether no-name give-up is a practice. We are looking at things as to whether we should separate the SRO function from SEFs. And so we are moving in the right direction, and it is something I can tell you that my committee that I sponsor will be looking at a lot more closely.

Mr. AGUILAR. Thank you, Commissioner.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Congressman LaMalfa.

Mr. LAMALFA. Thank you, Mr. Chairman. Welcome, Commissioners. Thank you for being here today as we sort through this ongoing subject.

Commissioners, in reference to position limits, as was touched on earlier, an important quote by former Commissioner Dunn, he said, "Position limits are, in my opinion, a sideshow that has unnecessarily diverted human and fiscal resources away from actions to prevent another financial crisis." To be clear, no one has proven that the looming specter of excessive speculation in the futures market re-regulated even exist, let alone played any role whatsoever in the financial crisis of 2008. Even so, Congress has tasked CFTC with preventing excessive speculation by imposing position limits. This is the law. So do any of you on this panel share Commissioner Dunn's view, and if not, how can we evaluate the effectiveness of any position limits that would be implemented by CFTC? Do you share any of those views?

Mr. WETJEN. Congressman, thank you for the question. I agree with Commissioner Dunn that it is the law that we impose Federal position limits. I think the best legal and statutory analysis of Dodd-Frank leads one to that result.

Mr. LAMALFA. He said a whole lot of stuff in the previous part of the quote that is pretty important too though, even if they are not——

Mr. WETJEN. Well, okay, if I——

Mr. LAMALFA. If nothing has been proven that, again, the specter of excessive speculation even exists, let alone played any role in the crisis of 2008.

Mr. WETJEN. Congressman, here is what I would say about that. When we proposed the position limits rule in the last instance, we had a presentation made by the Office of the Chief Economist, and I don't remember her precise words but basically what she represented at the open meeting was that there are an equal number of studies that show that there is a role for speculation in terms of pricing in the market, and then there is an equal number of other studies that come to a different result. So stating that more simply, the studies are a little inconclusive at the moment, but nevertheless, again, the best statutory construction leads me to believe that we have a mandate as an agency to impose the position limits. That is not to say that we have to impose inflexible position limits that just aren't workable. Congress gave us a number of different ways to make sure we have appropriate *bona fide* hedging exemptions eligible for the marketplace, for example. So that is my position. We are legally required to do it, but we need to impose a sensible and flexible position limits regime.

Mr. LAMALFA. Flexibility is key. We don't want to inhibit liquidity in the markets.

Commissioner Bowen, I wanted to touch on the data that is currently being used to design these limits. How current is that data, and would input from the industry be helpful in keeping that current or make it more up-to-date? How current is what you are using——

Ms. BOWEN. Right.

Mr. LAMALFA.—in this plan?

Ms. BOWEN. The staff has been working quite hard to make sure that the data that we receive is accurate and that it is useful. We have the ability to get market surveillance on a daily basis, and that is critically important to our ability to make sure that our markets are safe. We have made some great progress in terms of making sure that the data that we receive is relevant.

Mr. LAMALFA. How about current though? That was my key point in the question. How current is that data?

Ms. BOWEN. Well, every day we get data. We get reports every day. And so the data is, frankly, quite current.

Mr. LAMALFA. Now, does industry have a role in helping you to not only properly vet data but helping you to shape and use that data as well?

Ms. BOWEN. Yes. It will allow us to look at trends that may be happening in the market. One of the ways and one of the reasons we have position limits, frankly, is to make sure that there is no undue concentration by one market participant or any one particular product. So it is critically important for us to have that information to protect against excessive speculation.

Mr. LAMALFA. Thank you. Commissioner Giancarlo, you mentioned that it is important to have timely data. What if it is out-of-date, how harmful do you think this is in the process? I can think out-of-date data being used in other important aspects like, whether it is military or space travel, things like that, I mean it could be very important in this area. What is the effect, do you think?

Mr. GIANCARLO. Thank you, Congressman. Three weeks ago we held a meeting of our Energy Environmental Markets Advisory Committee at the CFTC, and our keynote speaker was Adam Sieminski, the Administrator of the U.S. Energy Information Administration, a Federal Government agency. He, on behalf of the Federal Government, studies movements in energy prices, and he said he sees absolutely no evidence of excessive speculation in the recent fall in energy prices, and yet, the CFTC is using more than 20 year old data for its estimates of deliverable supply for liquid natural gas.

Mr. LAMALFA. I need to yield my time, sir. I would like to follow up with you on that. Twenty year old data, you say?

Mr. GIANCARLO. Twenty year old data.

Mr. LAMALFA. Thank you. We will come back to you.

The CHAIRMAN. Mrs. Kirkpatrick.

Mrs. KIRKPATRICK. Thank you, Mr. Chairman, Mr. Ranking Member. And, Commissioners, thank you very much for being here today.

I really appreciate your comments on enforcement because rules and regulations really don't work unless there is adequate enforcement. And I will be honest with you, I opposed Dodd-Frank for that very reason because I didn't think we were adequately enforcing the rules and regulations we had in place at the time.

There is a rule 1.35 that requires records of communications be adequately kept, excuse me. In last year's bill, we removed that recordkeeping requirement. We know there has been a recent complaint alleging manipulation of the wheat market by a commercial end-user. In enforcement, we are always trying to balance the re-

quirements and the extra burden on the end-user, and then also the evidence needs to be preserved for prosecution. My question is, as a former prosecutor, do we need to revisit Section 353, and if that section goes into law, would it be more difficult for enforcement of these types of cases? So that is for the whole panel, I would like to know each one of your thoughts on that.

Mr. WETJEN. Congresswoman, I appreciate the question.

Mrs. KIRKPATRICK. Your microphone sounds like my voice.

Mr. WETJEN. So you referred to the section of the bill which would change rule 1.35 under our rules as it——

Mrs. KIRKPATRICK. Correct.

Mr. WETJEN.—exists today, and we proposed a revision to rule 1.35 last fall, and so we are in the process of deliberating internally about how to finalize that rulemaking. So there are some limits on what I can say, but here is how I am looking at this issue. There are two key points for me. The first is, if you are an entity that has not triggered registration because you are not engaged in the sort of activities that would require that, or if you have consciously chosen to change your activities in a way so that you don't have to register with the CFTC, and you are an end-user, that is meaningful to me. The second thing that I am looking at very carefully is, regardless of how we finalize this rule, it should not be done in a way that unnecessarily or unintentionally impedes access by an end-user to a particular marketplace. And so those are the two things that are animating my thinking as I am engaged in these deliberations.

I think it is really, really important to point out, Congresswoman, that rule 1.35 is only one recordkeeping obligation under CFTC rules. We have multiple recordkeeping obligations under our rules. If you are a member of a futures exchange or a SEF, you have recordkeeping obligations. And there are others as well. So, frankly, there has been perhaps more attention paid to rule 1.35 than is merited in a lot of respects. I understand the concerns that people have in complying with it, but it is very, very important for us to understand that, regardless of the revision of rule 1.35, there are other recordkeeping obligations that enable the enforcement division of our agency to perform its mission.

Mrs. KIRKPATRICK. Other Commissioners?

Mr. GIANCARLO. I will be brief, Congresswoman. Thank you for the question. I don't think I could express it better than Commissioner Wetjen just did. There are a lot of balancing factors that go into this, and I agree with all of those factors. I would just also add, as a general goal, the new regulatory framework we have put together with its shortcomings, which I have mentioned, is nevertheless one we want to work. We don't want to discourage membership in swap execution facilities or on registered exchanges. And the impact of rule 1.35 has been for a number of participants to say, "Well, then I just won't get involved as a direct member, I will work through an intermediary." What we want to do is bring more of them on to the platforms, not off.

And the final thing I will say is we have seen a diminution in the number of futures commission merchants of dramatic extent over the last several years. We are down to less than what we had less than 10 years ago. And this is another rule that FCMs are con-

cerned about in terms of adding to their costs, adding to their burdens, and not adding to their ability to survive in the marketplace. So those are two more factors to add into the balancing here.

Mrs. KIRKPATRICK. Ms. Bowen?

Ms. BOWEN. Yes, one of the reasons we have devoted so much time to this rule is because we are trying to seek the right balance. You are right, we need to make sure that enforcement has the capability to look back, and that is critically important to us. At the same time, we want to make sure that we don't have unintended consequences of making the rules so onerous that people either flee, or that we have shrinkage in our markets. We are doing a fairly good job in terms of making the correct balance. I think we will be out, hopefully quite soon, on a decision on that.

Mrs. KIRKPATRICK. Thank you.

My time has expired. Thank you, Mr. Chairman, for your indulgence. I yield back.

The CHAIRMAN. Mr. Davis.

Mr. DAVIS. Thank you, Chairman Scott, and thank you to each of the witnesses for being here today.

Commissioner Giancarlo, how is the swaps market different than the futures market, and how should those differences be taken into consideration when drafting rules and regulations for the swaps market?

Mr. GIANCARLO. Thank you for the question. The best way I can describe it is the swaps market is as different from the futures market as the bond market is as different from the stock market. The liquidity characteristics, the way in which instruments trade are very, very different. If a share of Microsoft trades an enormous continuous volume from the moment the Stock Exchange opens in the morning to the moment it closes, millions, if not tens of millions of trades per minute. The bond market, on the other hand, trades with much more episodic trading. Ford Motor Company's Series G 2028 Q5 bond may trade once a month, and I just made that up, I don't even know if there is such a bond, but it may trade once a month. It trades by appointment. Similarly, the swaps market, for the most part, what you get out of the very center of it, trades by appointment. And, therefore, trying to use futures instruments trade just like the Stock Market trade, highly liquid, constant liquidity. Trying to use futures models to trade swaps products just won't work. And one of the biggest shortcomings in our swaps execution transaction protocol is that we assume futures models, continuous order book electronic models, would work in swaps, and they are just not working in swaps.

Mr. DAVIS. Well, in your testimony you suggested ways that we here in Congress could help improve the SEF regime. Can you elaborate on those points, and which of these issues may keep you up at night?

Mr. GIANCARLO. Two very different questions. So in terms of where help can be, it would be in the core principles that I outlined directly in my testimony.

But I will tell you what keeps me up at night. What keeps me up at night is that, in our rule-writing, we are writing rules to prevent the last crisis, and we are creating the opportunity for a very different crisis. The last crisis was one of counterparty credit risk,

and we are doing everything to strengthen bank balance sheets, and to cause more capital to be put aside. But the next crisis, as they always are, will be a very different crisis, and I worry the next crisis will be a crisis of market liquidity; that there just won't be availability of the trading instruments that institutions will need to survive a crisis in the marketplace. And if you look at the same rules we are doing now, whether they be the Volcker Rule, the National Capital Rule, supplemental leverage ratios, position limits, proposals for transaction taxes, swap trading rules, all of these things are making liquidity, that means the ability to fund the other side of a trade much, much harder. And as we move things into central counterparty clears, into clearinghouses, I am worried in the event of another crisis those clearinghouses won't be able to sell instruments in order to gain the liquidity they need. So I worry, what keeps me up at night is that we are preparing for the last crisis, and doing things that are actually going to perhaps, if not cause, exacerbate the next crisis; a crisis of liquidity.

Mr. DAVIS. Thank you very much for your response.

Commissioners Bowen and Wetjen, have you reviewed the Commissioner's white paper, and if so, do you believe that any of the other recommendations are worth considering?

Mr. WETJEN. Congressman, I have reviewed the white paper and, as always, a very thoughtful piece of work by Commissioner Giancarlo, who has been such a great addition to the Commission.

The Commissioner is right that swaps do trade differently, but SEFs are different platforms than futures exchanges. There is tremendous flexibility in a SEF. It is not as flexible as a completely unregulated trading venue, which is what we saw before Dodd-Frank was passed, but there is enormous flexibility. Let me give you an example. Under the SEF rule, brokers can broker a trade just as they did back in 2008, so long as it is then sent to the SEF platform, just to see if there is a better price. And there are certain other limits, but the point is that by and large, that mode of execution permitted under the SEF today is very, very similar to how it has been done for a long, long time.

The Commissioner is right, we have requirements that there be the offering of an order book, but there is no mandate that anyone trade on the order book. The rule does not say you must trade on the order book. It does not. And order books don't work when there are instruments that don't have a lot of liquidity, as suggested. It also requires an RFQ that says that you have to send the request for a quote out to a minimum of three people. We fussed around on the right number of people that the quote—or request, rather, should be sent to. We settled on three. There is no particular magic in that number either, but the point is that, yes, if you are a SEF, you have to offer an order book, but no one has to trade there. In fact, we have seen SEFs that have order books with very limited trading in the order book. We say yes, you have to offer an RFQ, but importantly, we allow, or the SEF rule allows, brokerage of trades so long as they are crossed.

So that offers a number of different ways for execution, flexible ways for execution, particularly in the case of a cross, and even an RFQ to some degree.

The other thing that I—as I mentioned in my testimony, the preamble of our rule says we need to remain open to, and will consider, other modes of execution. And one of the things we at the agency need to do a better job on is analyzing those other methods of execution expeditiously, getting answers back to the SEFs, giving them some sense of whether they can be allowed or not. And in the analysis about whether they should be allowed, again has to reflect these two mandates under the statute; promoting trading on SEFs, but also promoting pre-trade price transparency.

Mr. DAVIS. Thank you. My time has expired.

The CHAIRMAN. All right. Mr. Emmer.

Mr. EMMER. Thank you, Mr. Chairman, and the Commissioners for being here.

Commissioner Giancarlo, we are concerned about the impact of CFTC Advisory 13–69 on cross-border swap activities. It is our understanding that this advisory triggers CFTC swap rules to be applied to transactions between two non-U.S. entities simply because a person located in the U.S. was used to arrange, negotiate, or execute the transaction.

Can you clarify for the Committee what it means to arrange, negotiate, or execute a transaction, and how such activities can import risk back to the United States?

Mr. GIANCARLO. Thank you for that question. I think a lot of the industry is trying to understand what those three words mean, and what impact they have on their business operations. But the context for this is that these swap execution rules, which I have criticized in my white paper, are meant to apply under an interpretive guidance that was issued by the Commission without cost-benefit analysis in the summer of 2013, are meant to apply to transactions between, effectively, non-U.S. persons. The staff guidance that you reference says that they also apply even if the transaction is between non-U.S. persons, all transaction rules apply if, as you say, a person in the U.S. arranged, negotiated, or executed the transaction.

Now, I will tell you that staff advisory has now been delayed four times, so it is not in effect, which the fact that it needs to be delayed four times tells you a little something about perhaps the efficacy of that staff advisory. But what to many people, myself included, it appears to say that if a transaction is taking place outside of the United States, entirely between non-U.S. persons, if somebody in the U.S. helped in that trade, and I will give you an example, let's say you have a Swiss pension fund looking to buy a credit default protection against the failure of a U.S. company, say, Ford Motor Company, but they are trading with a German bank, it is entirely two European persons, if one of those banks calls a sales associate in New York who may be the bank specialist in Ford Motor Company credit, just to say how is Ford looking these days, what are the ratings on Ford's bonds, are we comfortable advising this client in Switzerland to buy this bond from us in Germany, suddenly now this trade, at least under the advisory, is a U.S. trade and has to be done pursuant to all of our trade execution rules. What that really means is nobody is going to turn to that specialist in New York or Boston or Chicago or Charlotte any-

more, and that person has to worry about whether they are going to have a job next year.

Mr. EMMER. Commissioner Bowen, does the location of the individual negotiating a trade have a direct and significant impact on U.S. commerce if the trade occurs between foreign counterparties in a foreign jurisdiction? Is that a reasonable approach to cross-border regulation, do you think?

Ms. BOWEN. It is one approach, but I think——

Mr. EMMER. No, I was asking if it is a reasonable approach.

Ms. BOWEN. I think it is an approach, but I would suggest that we should follow where the risks actually lie. And so whether the person is located in New York *versus* London, in some respects, may not be indicative as to where the real risk is. And so we have global markets, the concept of a *U.S. person,* frankly, may be irrelevant because transactions will be taking place in cyberspace. So from my perspective, one of the reasons we have opened this up to comment is to look at all the different scenarios. And so that is one approach, but there are other approaches.

Mr. EMMER. Thank you.

Commissioner Giancarlo, in the short time I have left, there is concern about the CFTC's position limits rule and the new requirement that all *bona fide* hedge exemptions be evaluated by the Commission rather than by the exchange, as has typically happened with non-enumerated contracts. Inserting the Commission formally into this process of granting exemptions seems like a substantial commitment of new resources. Do you know how much new data the Commission will have to evaluate for this process, and how many man hours this will require of the Commission staff?

Mr. GIANCARLO. Thank you for the question. It is one of my concerns, and as we have talked about earlier about funding of the agency, this is an area where the agency is taking on things that could be well done by others. It has been tradition in the futures industry for the exchanges to operate a system of position accountability. Under our CFTC current proposal, they would not be involved in the process; everything would be done at the CFTC level through a series of hard limits on positions, not only in the spot month but in the outer month.

The CFTC has also narrowed the *bona fide* hedge exemptions from a much more—a longer list that was present before to a much narrower list with no unenumerated hedges. Specifically, the CFTC is not going to recognize storage transactions as *bona fide* hedges, merchandising and anticipatory hedges, cross-commodity hedges, and cross *versus* net hedging. These are all tools that have been used for a long, long time in the futures market, but under the CFTC's current proposal would not be *bona fide* hedges. That is not in the interest of many end-users of futures and swaps markets in the marketplace.

Mr. EMMER. Thank you. My time has expired.

The CHAIRMAN. The former Chairman of the full Committee, Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman. And I appreciate this hearing subject matter and our Commissioners being here today. It is very important.

Commissioner Bowen, I understand that you also have shared your concerns about regulatory clarity and how important that is. Let's visit for a moment in regard to cross-border guidance. As you know, the Commission staff issued a series of no-action letters, suspending the impact of an unexpected staff advisory letter which significantly modified the meaning of a footnote which was buried on the bottom of page 60 of that cross-border guidance. Let me think about this a minute. A series of no-action letters designed to suspend an unexpected staff advisory letter, which pertained to a footnote which was on the bottom of page 60 of an 80 page guidance. In a recent speech, you outlined three ways in which regulators can be unclear, and it seems that this particular example might hit the trifecta. After all, there was no notice of the proposed interpretation, the requirements of the interpretation have continually been delayed, and the significant change hinges entirely on a staff interpretation of a Commission guidance document. That is really pretty amazing actually.

Are you concerned, Commissioner, about how the Commission's cross-border guidance has been implemented?

Ms. BOWEN. That footnote has gotten a lot of attention, that is for sure, but let me say this. Where possible, obviously, in rulemaking, what the benefit of a notice and comment period is the way to really regulate, but at the same time we have tools that we can use as well. Guidance and interpretations are one of them. And, frankly, when we issue those, they are typically in response to a market participant seeking relief, or asking the question does this apply to me or not. And so it is a tool to allow us to be a lot more flexible, to respond much more quickly. So the process itself, I support that we use all the tools that we can be effective and to be responsive.

Mr. LUCAS. But you can understand——

Ms. BOWEN. I can't comment on that particular footnote, I wasn't there at the time.

Mr. LUCAS. But you can understand the general principle of a series of no-action letters sent out to suspend the impact of an——

Ms. BOWEN. Yes.

Mr. LUCAS.—unexpected staff advisory letter which pertained to the meaning of a footnote on page 60 of the 80 page document. You can understand why that might be a little confusing to both those of us looking over your shoulder and those trying to understand what you are doing. So I guess my question becomes this, and I will address this first to you and then the other Commissioners, what are we doing to try to not continue in this pattern of doing things this way? How do we get away from this system and what are we doing? I will start with you, Commissioner Bowen——

Ms. BOWEN. Okay.

Mr. LUCAS.—and then, of course, your colleagues if they would care to comment.

Ms. BOWEN. Sure. As I said before, in the best of all worlds, my preference, obviously, is to do rulemaking through comment and notice. That is our preference. At the same time, I would not want to take away the tool of having staff issue guidance or interpretive releases because they are responsive to questions that are being asked by the industry. So I would not take those tools away. I

think they are extremely important. I think they can be used really effectively.

I understand your frustration in terms of that footnote being buried. We have heard a lot about that footnote.

Mr. LUCAS. Because it almost implies that the process with which—that set off this chain reaction, there is something wrong with that or we wouldn't have had to have had this layering effect.

Gentlemen, any comments?

Mr. GIANCARLO. Congressman, you have put your finger on it. The problem with the abuse of the no-action letter process is it erodes the public's confidence in the agency's undertaking of its responsibilities, and second, it stymies our ability as an agency to inculcate a compliance culture in the companies that we oversee. It really hurts our own reputation and it makes it harder for us to do our job in terms of the companies we regulate.

Mr. LUCAS. Commissioner?

Mr. WETJEN. Congressman Lucas, it is a great question. I think one of the ways to avoid the need for unnecessary or plentiful no-action letters is to be sure there is maximum consensus in the policymaking in the first instance. That tends to be a good barometer and a good way of predicting what kinds of challenges, unexpected or otherwise, you might face or market participants might face. And usually, that means that if there is full consensus, it usually means that there has been a nice fulsome taking into account of the comment file. So that is one way to do it. But if I could just add one other thing, Congressman. We need to look at this in its proper context. We at the CFTC, we are given an enormous task to do. We had to pass more than 50+ rules to implement Title VII, so it is inevitable that in a process like that there are going to be unexpected compliance challenges. And we have been as responsible as we could be in responding to those, and this no-action relief is an important tool to use in that regard.

Mr. LUCAS. If the Chairman will indulge me for just a moment. I wholeheartedly agree, Commissioner. The magnitude and the scope of what was dumped in the lap of the Commission was far beyond what it should have been, set up in a fashion that was far more complicated, far more convoluted, and the process with which some of your predecessors interpreted it only made it more complicated, from my perspective. But that said, we cannot allow this way of doing business to become the new norm. We cannot allow this to be the standard way that we do things at the Commission. The confusion that it will bring amongst the participants, the confusion it brings in the market is just unacceptable. So that is my simple point to you; this cannot become the new norm, and I worry that that is where we are headed.

With that, I yield back, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Lucas.

We are going to get our second round of questions now. I am going to let Mr. Scott go ahead of me.

Mr. DAVID SCOTT of Georgia. Thank you.

I would like to get into the cross-border issues here because I have a concern that we need to be very careful as we deal with our foreign markets, our foreign competitors, that we not put our financial system, our financial industry, as both our market participants

and our end-users, in a non-competitive position. Issues like, for example, the push-out rule, which, to me, to push-out commodity swaps, for example, from the same bank in which you are doing the interest rate swaps, clearly puts our end-users as well as our banking system at a disadvantage. And my whole point that I want to ask on that is what are these other foreign markets doing? Are they doing the same thing? The other point I want to ask is how do you all measure, and in collaboration with the Securities Exchange Commission, what accounts for a robust regime that has the same measure and depth of regulation that we have when we go in, and we are going to allow that to happen? So on position limits, on the clearinghouse risk, on these issues, I know, Mr. Wetjen, you have put a lot of time into cross-border, if you could give us a little clarity on that. And you as well, and, Ms. Bowen, if you would like to comment on that, particularly on the push-out rule, I would be appreciative. Yes.

Mr. WETJEN. Ranking Member Scott, thank you for the question. You had asked what other markets are doing on the cross-border front, which I understood to mean where are they with respect to the reform effort. Back in 2009, the G20 convened in Pittsburgh and agreed to a series of reforms as it relates to derivatives. And there were several key points: increased transparency through reporting, clearing of liquid swaps, and then, where appropriate, trading of swaps on regulated venues. So all the G20 nations agreed to that.

They are in different states of the implementation stage as you look around the globe. Europe has done a great deal. They are beginning to impose clearing mandates. I don't think we are likely to see a trading mandate any time soon. Japan has a clearing mandate in place. They are expected to have a trading mandate in place later this year. So there is significant progress in those two jurisdictions, but as we have discussed earlier, we still—there is still a lag time between when our rules went into effect and when theirs are going into effect.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. WETJEN. And to be fair, there are some differences as well. So those are all going to have to be managed. That is why I say in my testimony that the appropriate thing to do is be sure that during this stage, as the rest of the G20 nations complete their process, we make sure our institutions in the U.S. are competitive, and back to the guidance, we took care to try and be sure that that is the case. And then once the rest of the nations have completed their task, we can look again and see how everything compares, how the global marketplace fabric is fitting together, and decide whether additional policy makings might——

Mr. DAVID SCOTT of Georgia. So——

Mr. WETJEN.—take place.

Mr. DAVID SCOTT of Georgia. So do any of you see where we are putting our American end-users, our American financial institutions in any phase of all of the issues of cross-border in a disadvantaged position with what is going on now? Is there any area we need to really worry about where we are putting our financial institutions or end-users, these folks operate all around the world and I want to see if we are putting them at any risk. Mr. Giancarlo,

you mentioned a little bit about that when you talked about the energy, the manufacturers, the farmers. I am very concerned about that. There are a lot of farmers in Georgia, and manufacturers like Coca-Cola. I mean we don't want to put them at——

Mr. GIANCARLO. Can I take a moment and walk you through? It is a somewhat complex issue but it does answer your specific question.

So clearly, one of the premises of Dodd-Frank was that we would find a way to ring-fence the American markets from imported risk from abroad. But one of our rules might have the effect of actually retaining risk within that ring-fence environment, and disable end-users, farmers, manufacturers' ability to hedge risk outside of the United States.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. GIANCARLO. And that is in the matter of internal risk transfer. The charging of an initial margin when an intermediary between an end-user and an overseas marketplace for a swap that may reduce the risk, when that intermediary, whether it is a bank or other financial house, has to charge initial margin on their own transaction between their U.S. affiliate and their overseas company. Now, I will give you an example that will clarify this. Let's say that John Deere, a tractor manufacturer that employs a lot of workers to build tractors, also has a plant in, let's say, Japan where they make steering wheels, for example, and they borrow in the Japanese currency to build and operate that plant, and yet their cost of borrowing is in U.S. dollars——

Mr. DAVID SCOTT of Georgia. Yes.

Mr. GIANCARLO.—they have risk of the Japanese interest rate changing, and that is real risk in this market. They may seek to hedge that risk in the Japanese marketplace and use a Japanese financial house, but if that Japanese financial house has to charge internal margin, the cost has now just gone up to John Deere, who may have a factory in Ohio, for example.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. GIANCARLO. And what that means is they won't hedge that Japanese Yen interest rate risk in Japan, they will hedge it in the United States. That is risk that we are warehousing here and not taking abroad.

So when we talk about ring-fencing our markets from risk, as Commissioner Bowen rightly puts it, these are global marketplaces.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. GIANCARLO. If you ring-fence from outside risk, you are also keeping internal risk in our own marketplace, and that is something we have to take account of.

Mr. DAVID SCOTT of Georgia. Okay. Very well stated. Thank you, sir.

The CHAIRMAN. Mr. LaMalfa.

Mr. LAMALFA. Thank you, Mr. Chairman. I appreciate you allowing me to go ahead here again with the other Subcommittees pending right now too.

Following back with Mr. Giancarlo, you were speaking earlier about timeliness and up-to-date data, and you were talking about in energy, negative effects, 20 year old data, was this affecting swaps or swap dealers, please elaborate.

Mr. GIANCARLO. Thank you for the question. So one of the parts of our position limits rules is that the CFTC will determine what the appropriate limits are based upon what is called deliverable supply estimates; what is the available supply of an instrument by which one may hedge in. It is very important to have up-to-date data. My understanding is the data we are using for position limits in gold and silver is 30 years old. It goes back to the 1980s. The data we are using for liquid natural gas is based on 1990s data.

Now, everyone knows that we have had a complete revolution in the production of natural gas in the United States in the last 6 or 7 years.

Mr. LAMALFA. There have been some changes, yes. We have——

Mr. GIANCARLO. There have been dramatic changes, and yet we are still using 20 year old data to determine deliverable supply.

Mr. LAMALFA. Why is it? Why are we stuck in that?

Mr. GIANCARLO. I don't know the answer.

Mr. LAMALFA. How do we fix it?

Mr. GIANCARLO. Well, certainly, I and the Commission are calling for the use of contemporary data to set these deliverable supply estimates. I don't know how, in a modern economy, as a world-class regulator that we strive to be, that we could be using out-of-date data to set deliverable supply estimates.

Mr. LAMALFA. We look forward to working with you on how to accomplish that.

Mr. GIANCARLO. I would be delighted to keep you apprised of how that comes along.

Mr. LAMALFA. Thank you.

In my remaining time, Commissioner Bowen, switching gears here a little bit. The proposed *bona fide* hedge rules ignore existing commercial market practices of allowing a market participant to obtain a hedge exemption in the spot month for unfixed price purchases and sales on fixed contracts or legitimate hedging tool for sellers, yet these will no longer be allowed under the rules. Why is the Commission seeking to take away this longstanding legitimate hedging tool from farmers? Does this change your longstanding exemptions meet your definition of *regulatory clarity* that was discussed earlier? So again, why is the Commission looking to take away this longstanding hedging tool from farmers?

Ms. BOWEN. Right. As you know, that is a subject that we have looked at, or continue to look at, but as you know, it is important that farmers can use hedging to hedge against legitimate commercial risk. That is critically important. And so we don't intend to put obstacles in their way to prevent effective market risk-taking activity. That is really not the point. I don't believe that we are managing the process and receiving comments that would suggest that we would create new obstacles. That is not what we are doing. We are trying to be practical——

Mr. LAMALFA. The proposed—again, the proposed rule——

Ms. BOWEN. It is a proposed rule, yes.

Mr. LAMALFA. Yes. Well, then the proposed rule hanging out there is——

Ms. BOWEN. Yes.

Mr. LAMALFA.—a concern for people that it would be implemented and taking away that——

Ms. BOWEN. Yes.

Mr. LAMALFA.—existing ability to use these practices. So what is—I mean how do we——

Ms. BOWEN. Yes, I mean——

Mr. LAMALFA.—this proposed rule on the backburner then?

Ms. BOWEN. No, what we have done with the proposed rule is we have opened it up for comments, we are reviewing the comments that we receive from the industry, and we are making sure that——

Mr. LAMALFA. How are the comments looking? Pardon my interruption, but how are the comments——

Ms. BOWEN. They are fairly comprehensive.

Mr. LAMALFA.—looking?

Ms. BOWEN. We have received hundreds of comments from many end-users.

Mr. LAMALFA. And are the percentages running heavily one way or the other on the——

Ms. BOWEN. I can't comment on that specifically, but I am happy to meet with you later on that.

Mr. LAMALFA. All right, please if you could submit a statement to my office or my staff on that, on how that looks, because I would imagine it would be pretty overwhelming, given the feedback we are getting so far on this, that they are not at all in favor of the proposed rule and that it should likely be scrapped, or some other angle taken on that.

The follow-up question on that, does this change to the longstanding exemptions meet your definition of *regulatory clarity* that was discussed earlier on? Regulatory clarity, does this meet that goal? Do we need that?

Ms. BOWEN. Well, again, the point in having and receiving comments from the industry is to make sure we take into account all viewpoints, and the way to——

Mr. LAMALFA. Well, one of the things you defined earlier is looking for regulatory clarity.

Ms. BOWEN. Correct.

Mr. LAMALFA. Does the industry feel like it has enough clarity already, or is this something that is entirely being——

Ms. BOWEN. I think the industry——

Mr. LAMALFA.—brought up——

Ms. BOWEN.—is seeking more clarity, sir. I really do. I think the industry would like for us to give them more clarity, and that is our job as regulators.

Mr. LAMALFA. But I run into that again and again when people have longstanding practices they are pretty comfortable with——

Ms. BOWEN. Yes.

Mr. LAMALFA.—and Federal Government comes up with additional clarity, it actually harms those folks who—we are talking farming and ranching practices in regards to water, environment, whatever. Clarity has generally closed doors to them, and that is what I am hearing here, so please be apprised of how people are feeling about when clarity gives them less options. Okay, and we look forward to previous information on how those comments are going. If you could submit——

Ms. BOWEN. Yes.

Mr. LAMALFA.—submit that to my office——

Ms. BOWEN. Happy to, sir.

Mr. LAMALFA.—the Committee, with the Chairman's permission. Thank you.

The CHAIRMAN. Mrs. Kirkpatrick.

Mrs. KIRKPATRICK. Commissioner Giancarlo, I really appreciate your comment that we may be too focused on the past financial crisis and not enough on the future, which you identify as a crisis in market liquidity. And, Mr. Chairman, and Ranking Member Scott, I hope you would consider maybe having a hearing of this Committee specifically on that issue.

But, Commissioner, very briefly, could you just give us a framework for what you see as that crisis, where that happens and maybe just a framework of how we could put into place some safeguards to maybe prevent that?

Mr. GIANCARLO. Yes, it is very hard to have a crystal ball as to what——

Mrs. KIRKPATRICK. I appreciate that, but it is something——

Mr. GIANCARLO. Yes, of course.

Mrs. KIRKPATRICK.—we should talk about.

Mr. GIANCARLO. What I start from is I look at the measures that we are putting in place now, and there is sort of a net impact of these measures. So many of the measures, they are all banking-driven measures. They are all measures to strengthen the balance sheets of institutions. And in strengthening balance sheets, which is a worthy goal, there is no question about it, what that does is those institutions are not putting that capital to work, it is sitting on their balance sheet. So that capital is not in the marketplace to make markets, to transact at markets, it is not available to end-users and other market participants to put that capital to work. So let's look at some of the rules we have put in place. The Volcker Rule, the Basel Capital Requirements, the supplementary leverage ratios, these are all capital-constraining provisions. And then add on top of it our own proposed position limits rule which, in certain parts of the marketplace, will perhaps take out participants who would normally be there providing liquidity. And then there is talk about different swaps trading, or trading taxes or transaction taxes, whatever the merits of that proposal would have another liquidity-reducing impact on the marketplace. And then there is an additional margin on uncleared swaps. So all of these initiatives all have important purposes and constituents and momentum behind them, but every one of them has a liquidity reduction impact to it. And I don't know what provisions are going into place that have liquidity-enhancing elements to it. So I do worry that the net impact of important rulemaking though will be to take liquidity out of the market. When a crisis comes, that is when everyone pulls back, and I am worried that, in the face of all these requirements, the warehouse capital on bank balance sheets, they will pull back in the event of crisis.

And the last point on this: I was in the markets in 2008 during the financial crisis. It was not a crisis of liquidity. Even the swaps market was liquid throughout the financial crisis. Banks were in the market buying and selling, making liquid markets for market

participants. I wonder if in the next crisis they will remain in that same posture or whether they will pull back from the marketplace.

Mrs. KIRKPATRICK. I really appreciate that. That was exactly my concern at the time, that we would overreact in a way that would hurt us in the future.

And any other Commissioners want to address that?

Mr. WETJEN. Congresswoman, it is a great question, and something I have given some thought to as well. As Commissioner Giancarlo says, a large result because of prudential requirements on traditional banking institutions we have seen some of the retreat from liquidity provision by the same institutions, whether that is in the previous markets or other markets as well, including the bond markets. So to me, one of the solutions has to be how do we open up these marketplaces to additional different types of non-traditional liquidity providers. As Chris Giancarlo and I have discussed, there are risks that come along with that as well because, in a lot of cases, these non-traditional firms have practices or execution strategies, or what have you, that they are electronic, automated, and so consequently carry with them different types of risks that also have to be managed. We do have a series of risk controls in place for our exchanges and for our intermediaries to try and address that. We are looking at other measures that we might impose on these types of firms so risk controls are applied to the trading firms themselves. But to me, that is something, as policymakers, we need to be open to because there seems to be a lot of consensus behind some of these additional prudential requirements on traditional banks who are important liquidity providers. So part of the solution, it just seems as a matter of logic, has to be, okay, well, how do we bring in other liquidity providers, non-bank liquidity providers, and what kind of risks do they pose that are different from the traditional ones, and how do we manage those risks.

Mrs. KIRKPATRICK. Well, thank you. My time has expired, but I do hope this is something the Committee will look at.

Thank you, and I yield back.

The CHAIRMAN. Yes, ma'am, and I'd like to point out on that same issue, Chairman Conaway and Ranking Member Peterson have both sent a letter to the Prudential Regulators expressing some of the same concerns, and that that is something that the leadership of the Committee, both Democratic and Republican, have, and we will be spending a lot of time on that particular issue and making sure that we get it right.

Commissioner Bowen, this is pretty much for you, but I will ask the others to follow up as well. It relates to the *Financial Times* article on Sunday that indicated that according to data from the CFTC, the number of registered futures commission merchants is down significantly to 71 at the end of February, which is down from 91 a year earlier, and 189 in 2005. It is my understanding that you are the sponsor of the Market Risk Advisory——

Ms. BOWEN. Yes.

The CHAIRMAN.—Committee, and my concern is that the drastic reduction in the number of clearing members could lead to additional systemic risk, and I would just like for you to speak to that issue if you would.

Ms. BOWEN. Yes. Thank you for that question. And that is an issue that we are looking at. We are concerned whenever there is concentration that reduces the number of platforms and places where end-users can go, so that is something we will definitely take a look at. I will say though I do think the current interest rate environment probably contributes somewhat to the reduction, but we will take a look at other sources as well. But on your question about concentration of risk as well, our committee is looking at clearinghouses, and its impact and its default management regimes, again, as a way to address any concerns as to whether we are creating more risk. And so I look forward to looking at both of those issues more in-depth.

The CHAIRMAN. Yes. Would each of you speak to that as well, the loss of members?

Mr. WETJEN. Chairman, that is an issue that I mentioned in my written testimony: the concerns around FCM concentration. Commissioner Bowen is right; a lot of the reason why we have seen some institutions getting out of the clearing brokerage business is because of the low interest rate environment. There are limits on what kinds of investments can be made with customer monies that are taken in by the members, and so again, with the low interest rate environment, you just aren't getting the same kinds of returns as you used to see before. And so that explains to some degree what we have seen in terms of the retreat by some of these FCMs.

The other reason is, as we discussed before, some of the additional prudential requirements on these same institutions have made the business more difficult. So we have to be mindful of that. As you alluded to, if we have too few a number clearing members and FCMs, it is going to lead to problems with respect to accessibility in the marketplace, particularly by the end-user community.

Mr. GIANCARLO. Two points. Briefly, Mr. Chairman, of that number of 74, so FCMs is probably closer to 50 that are actually serving farmers, ranchers, and manufacturers. We are also seeing a concentration of futures commission merchants with major dealer banks, and less and less smaller FCMs which are the traditional service providers to smaller end-users. So this is a real concern.

My fellow Commissioner is absolutely right that the low interest rate environment hurts their business model, but we need to be very careful with the regulations that we are piling on them that those—the cost of complying with regulations is also not difficult for them.

And I just want to add one other thing. Commissioner Bowen held an excellent meeting of her sponsored committee, the Market Risk Advisory Committee, a few weeks ago, in which we heard from some of these non-traditional liquidity providers that Commissioner Wetjen mentioned, and that is a real opportunity. These advisory committees operated at the CFTC are one of the unique aspects of our agency, and they provide very valuable input to a lot of the questions that we have been discussing today. Thank you.

The CHAIRMAN. Thank you. Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman. Thanks for allowing us a second round of questions. Sometimes the 5 minute limit is not as accommodating as the five-times limit that you guys deal with.

Commissioner Giancarlo, the Commission recently offered no-action relief for Southwest Airlines from its hedges in illiquid markets, and some have questioned the Commission's rationale for not broadening that relief to any similarly situated market participant, in effect, requiring a hedger to come to the CFTC and plead the same case over and over again. Would you support offering broad relief to any market participant who is similarly situated in illiquid swaps markets?

Mr. GIANCARLO. Yes, I would. I found that matter to be quite interesting because it actually illustrates the point I made earlier in response to your question about how the swaps market is different than the futures market. As I mentioned, liquidity in the swaps market is very different. There are a number of very important market participants, such as Southwest Airlines, that are engaged in transactions that just can't settle in a day, 2 days, 3 days, and it may take longer, and our rules need to be much more open to that. It should not be an exception to our rule that there are transactions like that. Our rule framework should accommodate transactions like that. And market participants shouldn't have to come cap in hand to the CFTC with a question that says, "Mother, may I," to engage in a transaction that is just part of their everyday business of serving their customers. Our rule framework should allow for that because that is the nature of the swaps market. It is very different than futures; it is the nature of the swaps market.

Mr. DAVIS. Thank you. Commissioner Bowen, do you agree?

Ms. BOWEN. I think this is one instance, in fact, where the response to a request for relief in no-action, which is why it is critically important that we don't do away with those tools. To the extent that there may be other participants that are in the same situation, they should come forward and seek relief.

Mr. DAVIS. So on an individualized basis?

Ms. BOWEN. I think that case is, frankly, quite unique. I think part of it had to do with whether or not the disclosure of their hedging strategies, whether that itself would change the pricing for them.

Mr. DAVIS. Okay.

Ms. BOWEN. But it was quite unique.

Mr. DAVIS. No other airlines have come and said we want to see this happen?

Ms. BOWEN. Not that I am aware of.

Mr. DAVIS. Okay. Commissioner Wetjen?

Mr. WETJEN. I do think that you are referring to the relief on the real-time reporting obligation, and there was relief given to Southwest Air. I think we should try and deal with issues like that on more of a broad basis than an individualized basis, and if there is, in fact, an unintended effect on liquidity based on reporting, it does stand to reason that it could be impactful for other market participants as well. So it does make you wonder, well, does something need to be addressed in the timing of the reporting of those particularly long-dated swaps. So it is something we should revisit.

Mr. DAVIS. Great.

Mr. WETJEN. And incidentally, Congressman, I expect we will probably get requests, and you might have that on your mind when

you asked that question, but I wouldn't be surprised if we get requests from others.

Mr. DAVIS. Absolutely. Thank you. Thank you for your response.

Commissioner Giancarlo, Ranking Member Scott asked a question on requiring margin, and I would like to ask a follow-up to that. And on internal risk management swaps, does requiring the margin on internal risk transfer trades improve the systemic safety of our markets?

Mr. GIANCARLO. I know that has been argued, but I don't honestly appreciate how it does. So the answer is I don't see how that does improve systemic safety. I think, in fact, if anything, it probably adds to systemic risk because it causes risk to be kept within the United States as opposed to allowing hedgers to hedge risk in markets outside the United States where they might find greater liquidity. So in the example I gave of John Deere, if they have to pay more because their agent they are using in that instance to hedge outside the United States has to charge internal margin because of CFTC rules, then that added cost will just have that domestic end-user, John Deere in my example, say, "You know what, it is too expensive to hedge outside, we will hedge inside." So the risk is remaining here, not being exported outward.

Mr. DAVIS. Thank you. My time has expired.

The CHAIRMAN. Mr. Emmer.

Mr. EMMER. Thank you, Chairman Scott.

Commissioner Wetjen, although the reporting rules were the first set of rules to be finalized, much has been made of the Commission's difficulty consolidating and analyzing trade data. Last summer, the Commission solicited comment on potential improvements to the reporting rules. Can we assume that many of the comments identified, both problems and suggested solutions, and what does the Commission plan to do with the information received through this process, and when will a plan be implemented?

Mr. WETJEN. Thank you, Congressman. There is going to be action, there should be action, and the first matter we are going to address is what to do about trades that begin bilaterally, but then become cleared, and what are the different reporting obligations for the bilateral parties in the first instance, and then for the clearinghouse once it becomes cleared. So there has been some work on that. There has been confusion under the existing rules because a lot of times it appears from the data that the original swap that ultimately was cleared is still outstanding, and once it is cleared it becomes novated and so that is no longer the case. So that has the effect of bringing inaccuracies to the data set, so we need to address that.

Mr. EMMER. Can you answer my question though about when will a plan be implemented?

Mr. WETJEN. Well, that is just one particular rule that will come from the solicitation of comments. When that happens, the rulemaking identified, when that happens I am not sure. I have been briefed by the staff at the agency about it, but we have not seen an actual recommendation. We have seen nothing in writing. My understanding is that we should see something relatively soon but I can't say for sure.

Mr. EMMER. Relatively soon. Is that like this month or next month, or——

Mr. WETJEN. I don't have the answer to that.

Mr. EMMER. All right, thank you.

Commissioner Giancarlo, in your opinion, does the CFTC currently have the necessary technology to monitor the massive amounts of new swaps data that flow into the Commission on a daily basis, and what is the ultimate goal of the Commission with respect to collecting this type of date?

Mr. GIANCARLO. The situation we find ourselves in something that, out in Silicon Valley and other places where they use enormous amounts of data, firms like Google and Facebook and others, they call that big data: the emerging science of how to analyze enormous amounts of data. Well, as a government agency, we find ourselves with a big data problem as well, but without all of those terrific tools and talents and training that they have out in Silicon Valley.

It is something we are going to have to move much further in. Dodd-Frank has charged us with enormous responsibility in terms of gathering data, analyzing data. It is something that should be broadly supported as a mission. As someone who was in the markets during the financial crisis, it was clear that there was not accurate data of which institution had exposure to which institution, and it is part of the reason why the TARP Program was as broad as it was, simply because the lack of real ability to discern the absolute exposures of one institution to another. We do have to master the big data problem, but that is a very, very difficult thing to do. Some of the brightest minds in the world are moving into this new emerging science and we need to catch up with it.

Mr. EMMER. All right. Commissioner Bowen, that was the extent of my questions, but I saw you start to lean forward so I wondered if you had a comment on that same question.

Ms. BOWEN. No, I was just going to echo the need for us to have the capability to be relevant and up-to-date with the market. And yet again, another reason why we could really use additional funding.

Mr. EMMER. Thank you. I yield back.

The CHAIRMAN. Thank you.

And before we adjourn, I understand that Congressman Scott may have an additional question, and I would like to recognize him for that, and as the Ranking Member, allow him to make any closing remarks that he may have.

Mr. DAVID SCOTT of Georgia. Thank you, Mr. Chairman. I thought it would be good for us to ask this question because we are going to have to put together a new bill for reauthorization of CFTC. We had a previous bill, H.R. 4413. So give us your thoughts on how you feel any suggestions, recommendations, if you have read over any of this, that you would instruct us as a Committee that we can improve upon this work. Any thoughts?

Ms. BOWEN. I am happy to say that for many of the things that are in the bill, we as a Commission have already begun to address those. I think to the extent that we really need flexibility as regulators, it is really our job to be able to be responsive to the market, and sometimes it could be complicated to have things codified that

may not give us that flexibility. So I would urge that you give us as much flexibility as possible.

Mr. DAVID SCOTT of Georgia. All right.

Ms. BOWEN. As I said in my opening statement, if you could find a way to impose additional user fees or ways for us to fund ourselves——

Mr. DAVID SCOTT of Georgia. Yes.

Ms. BOWEN.—that would be greatly appreciated.

Mr. DAVID SCOTT of Georgia. Good. All right, thank you. Yes, Mr. Giancarlo?

Mr. GIANCARLO. If I could, Ranking Member, I would like to just suggest five areas where the reauthorization bill could benefit the industry generally, and the CFTC's work specifically.

We took action with regard to special entity utilities, the small, taxpayer-owned utilities, but supporting that in a reauthorization bill would underline the work we have done at the Commission level.

Second, I have mentioned improvement in the core principle for swap execution facilities.

Mr. DAVID SCOTT of Georgia. You said special——

Mr. GIANCARLO. Entity utilities.

Mr. DAVID SCOTT of Georgia. Entity utilities.

Mr. GIANCARLO. Yes, these are the small, taxpayer-owned electric utilities and others.

Mr. DAVID SCOTT of Georgia. Okay.

Mr. GIANCARLO. The core principles for swap execution facilities, which I mentioned, I believe the Congress got most of Title VII quite right at the beginning, but the core principles were lifted out of the core principles for futures exchanges——

Mr. DAVID SCOTT of Georgia. Yes.

Mr. GIANCARLO.—and there is some work that needs to be done there in a few instances, which I have laid out in my written testimony.

Mr. DAVID SCOTT of Georgia. Yes.

Mr. GIANCARLO. The swap dealer *de minimis*, as I said before, I really feel that that level should not be lowered unless we read, interpret and make a decision based upon the study that we have already authorized to do——

Mr. DAVID SCOTT of Georgia. Yes.

Mr. GIANCARLO.—and Congressional support for that would be very helpful.

There is a provision in Dodd-Frank with regard to indemnifying overseas regulators if they seek information from our swap data repositories. That has been an irritant between regulatory relations between ourselves and our European counterparts for years now, and I know there has been talk about removing that indemnification language, and I would highly encourage the Committee to put that in the reauthorization language. It would help us do our mission at the CFTC.

Mr. DAVID SCOTT of Georgia. But to your knowledge, is there any opposition to removing that? It makes sense. Is there anybody against that that you know about?

Mr. GIANCARLO. I haven't heard of any.

Mr. DAVID SCOTT of Georgia. Okay.

Mr. GIANCARLO. I am not aware of any. I will check with my staff, and if there is, I will make you aware.

Mr. DAVID SCOTT of Georgia. Okay.

Mr. GIANCARLO. And then finally, the initial margin charged on those internal risk transfers that I discussed a few moments ago——

Mr. DAVID SCOTT of Georgia. Yes.

Mr. GIANCARLO.—with the number, that would be an area where, if we seek to really think about systemic risk, that is one area where actually the effect of it is to warehouse risk in the United States, not export it. So I would ask that you think about that as well.

Mr. DAVID SCOTT of Georgia. Okay. Mr. Wetjen?

Mr. WETJEN. I agree with Commission Giancarlo. I think the indemnification provision under Dodd-Frank should be eliminated. It has created too many difficulties and it just needs to be changed. I would echo what Commissioner Bowen said about whatever the Congress does, it is important that it leaves with the agency sufficient flexibility to adjust to the changing circumstances. And so any authorities, we need to bear that in mind and——

Mr. DAVID SCOTT of Georgia. All right.

Mr. WETJEN.—and that would be helpful and allow us to continue executing our mission.

Mr. DAVID SCOTT of Georgia. Thank you. We added indemnification eliminated, flexibility, funding, special entity utilities.

Now, last question I want to ask. I want to go back to you, Ms. Bowen. We have this serious threat now of cybersecurity, and I know you have sunk your teeth into this. How serious a threat is it, and is the threat greater, for example, particularly our critical clearinghouses and exchanges and the third parties that they have to—how far does the threat go and what are we doing? It is a big territory out here we have to cover because there are so many players; the clearinghouses, exchanges, the companies. How serious is this threat?

Ms. BOWEN. I think it is a serious threat, and we can try to put the best practices and protocols in place, and have different levels of protection, if you will, so that those that are most at risk or have the most risky products would have to have measures in place that are specific to them and additional ones. The weakest link is what makes us vulnerable. So the extent that our markets are so interconnected, and to the extent that our participants rely on third party vendors, there are different ways that someone could, in fact, wreak havoc to our system. It is critically important that we allow our participants to have really robust systems in place, and that we have the ability as a Commission——

Mr. DAVID SCOTT of Georgia. Let me just ask——

Ms. BOWEN.—to make sure they are doing that.

Mr. DAVID SCOTT of Georgia.—the Chairman is going to pull—specifically, how do you judge the protections against for cybersecurity with the exchanges and the clearinghouses? I think those are very critical. Are there any variations there with clearinghouses or the exchanges?

Ms. BOWEN. Yes, the types of protections that you want to have in place should be equally as robust.

Mr. DAVID SCOTT of Georgia. I know, but are there any alarm bells that have been——

Ms. BOWEN. That have happened so far?

Mr. DAVID SCOTT of Georgia. Yes. To your knowledge.

Ms. BOWEN. Not yet.

Mr. DAVID SCOTT of Georgia. All right. Let me just end by saying thank you, Mr. Chairman. It has been another very good hearing, and it is a joy working with you. And thank you, Commissioners. I appreciate your testimony.

The CHAIRMAN. I too would like to thank you all for being here and taking the time to advise us, and for the work that you do. And as I have said, I look forward to a bill that balances that access and integrity, and moving that piece of legislation hopefully sooner rather than later. So we will be working hand in hand with you to get that language correct.

And with that, under the rules of the Committee, the record of today's hearing will remain open for 10 calendar days to receive additional material and supplementary written responses from the witnesses to any questions posed by a Member.

The Subcommittee on Commodity Exchanges, Energy, and Credit hearing is now adjourned.

[Whereupon, at 12:00 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED QUESTIONS

Response from Hon. Sharon Y. Bowen, Commissioner, Commodity Futures Trading Commission

Question Submitted by Hon. Randy Neugebauer, a Representative in Congress from Texas

Question. The CFTC issued proposed rules, which define *bona fide hedging* and include a finite list of transactions that would be considered *bona fide* hedges under the proposed rule. At a meeting of the Energy and Environmental Markets Advisory Committee last month, members of the committee representing the end-user community provided examples of typical transactions used by their companies to hedge risk in the ordinary course of business that would not be given *bona fide* hedge treatment under the proposed rule. As currently proposed, the rule would severely restrain hedging in energy markets and result in risk premiums being added to energy prices and causing consumers to pay higher prices. No explanation was provided at the EEMAC meeting for disallowing the transactions to be treated as *bona fide* hedges.

Commissioners, has any reasonable explanation been identified to date for not including historically accepted transactions as *bona fide* hedges under the proposed rule? What are your plans to follow up and ensure that the hedging needs of end-users are not severely constrained and that the final rule addresses speculative activity, as intended, and not the legitimate hedging activities of end-users?

Answer. Thank you for the question. As you know, the Commission is currently considering comments received on its proposed position limits rule following the closure of the most recent comment period. The Commission has received many comments from commercial end-users with suggestions for how the rule could be improved, including comments addressing what types of transactions are covered under the definition of *bona fide hedging.* I look forward to carefully reviewing those comments. Allowing end-users to utilize the markets to hedge is at the very heart of our futures markets and the Commission needs to preserve their ability to do that. As the Commission moves forward in its consideration of this matter, I will carefully consider how the rule can better facilitate commercial hedging while still guarding against excessive speculation and market concentration.

Response from Hon. J. Christopher Giancarlo, Commissioner, Commodity Futures Trading Commission

Question Submitted by Hon. Randy Neugebauer, a Representative in Congress from Texas

Question. The CFTC issued proposed rules, which define *bona fide hedging* and include a finite list of transactions that would be considered *bona fide* hedges under the proposed rule. At a meeting of the Energy and Environmental Markets Advisory Committee last month, members of the committee representing the end-user community provided examples of typical transactions used by their companies to hedge risk in the ordinary course of business that would not be given *bona fide* hedge treatment under the proposed rule. As currently proposed, the rule would severely restrain hedging in energy markets and result in risk premiums being added to energy prices and causing consumers to pay higher prices. No explanation was provided at the EEMAC meeting for disallowing the transactions to be treated as *bona fide* hedges.

Commissioners, has any reasonable explanation been identified to date for not including historically accepted transactions as *bona fide* hedges under the proposed rule? What are your plans to follow up and ensure that the hedging needs of end-users are not severely constrained and that the final rule addresses speculative activity, as intended, and not the legitimate hedging activities of end-users?

Answer. Chairman Scott and Ranking Member Scott,

I appreciated the opportunity to testify before the Subcommittee on Commodity Exchanges, Energy, and Credit on April 14, 2015. I was pleased to share my views on important issues facing the Subcommittee as it prepares to reauthorize the Commodity Futures Trading Commission ("CFTC"). Below, I respond to the supplemental questions for the record from Rep. Neugebauer.

With respect to the first part of Rep. Neugebauer's question, whether "any reasonable explanation [has] been identified to date for not including historically accepted transactions as *bona fide* hedges under the proposed rule[,]" unfortunately, the short answer to this question is "NO." No reasonable explanation has been identified.

As you know, Congress instructed the CFTC to implement a *bona fide* hedging exemption so that hedging positions do not count towards position limits.[1] I have repeatedly raised the concern that "the effect of the CFTC's [proposed] *bona fide* hedging framework is to impose a Federal regulatory edict in place of business judgment in the course of risk hedging activity by America's commercial enterprises."[2]

To explore these concerns, I directed the CFTC's Energy and Environmental Markets Advisory Committee ("EEMAC"), which I sponsor, to focus on the CFTC's position limits proposal.[3] The EEMAC devoted an entire panel at its public hearing on February 26, 2015 to examining the *bona fide* hedging portions of the proposal. Market participants described several "bread-and-butter" hedging transactions used in the energy industry, such as hedging costs for storing and/or transporting energy commodities as diverse as electricity, natural gas, oil, and other distillates.[4] Although *bona fide* hedging status is—and has historically been—available for all of the trades involved in these transactions, the CFTC has proposed to do away with that status and count these obviously risk reducing trades as speculative activity.[5] When asked to explain the denial of *bona fide* hedging treatment for commonly used hedging transactions, the CFTC staff was not able to articulate a satisfying explanation.[6] The staff suggested that an exemption of this kind could be abused and used for speculative purposes,[7] but EEMAC members conclusively rebutted those concerns.[8]

The full answer to Rep. Neugebauer's first question, then, is: No, the CFTC has not put forward any reasonable explanation for not including historically accepted transactions as *bona fide* hedges under the proposed rule. Secondly, Rep. Neugebauer asked "[w]hat are your plans to follow up and ensure that the hedging needs of end-users are not severely constrained and that the final rule addresses speculative activity, as intended, and not the legitimate hedging activities of end-users?" The first prong of my plan was, as described above, to ask that the EEMAC examine the issue of *bona fide* hedging in detail. After analyzing the evidence adduced at the February 26, 2015 EEMAC meeting and the subsequently filed comment letters, I have determined that the CFTC must substantially adjust its approach to *bona fide* hedging before I can support a final position limits rule.

As I described in my full written testimony and summarize below, the evidence presented at the EEMAC meeting and the subsequent comment letters filed with the CFTC make clear that the CFTC's proposed *bona fide hedging* definition is deeply flawed. It is important to remember that Congress intended that position limits target those who engage in "excessive speculation," while leaving hedgers to their task of reducing risk in their businesses. The CFTC's proposal unduly focuses on "limiting the activity of commercials in hedging in the markets," which in turn increases the risk of pricing commodities, the cost of which "is ultimately borne by consumers."[9]

The clearest and potentially most harmful limitation on the marketplace is the CFTC's proposal to limit the entire universe of transactions that can receive *bona fide* hedging treatment to a limited number of "enumerated" hedges. If a transaction does not fall into one of these categories, it is not entitled to the *bona fide* hedging exemption to position limits, even if the particular position is risk reducing and is a common, "bread and butter" transaction widely used in the market.[10] To make matters worse, the CFTC has proposed to repeal its current system in which market participants can submit proposed risk reducing transactions that the CFTC in turn reviews on a timely basis to determine whether such trades can be considered *bona fide* hedging transactions.[11] The repeal of this process will stifle flexibility and enhancements in risk management, thereby raising prices and hindering overall energy markets. I cannot accept these proposed changes, which will have the effect

[1] *See* 7 U.S.C. § 6a(c); J. Christopher Giancarlo, Keynote Address of Commissioner J. Christopher Giancarlo: *End Users Were Not Source of the Financial Crisis: Stop Treating Them Like They Were,* (Jan. 26, 2015) ("Keynote"), available at *http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlos-3*.

[2] Keynote.

[3] *Position Limits for Derivatives,* 78 FED. REG. 75680 (Dec. 12, 2013) ("Proposal").

[4] EEMAC Meeting Transcript, 163–79 (Feb. 26, 2015) ("EEMAC Tr.").

[5] *Id.* at 168–79; 174–79.

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Id.* at 157–58, 183.

[10] *Id.* at 160–61.

[11] *Id.* at 177–78.

of stifling the innovation and dynamism that are at the heart of U.S. energy and commodity markets.

Let me briefly summarize a few elements of the CFTC's significant reduction of the *bona fide* hedging exemption:

1. Storage Transactions

In a reversal from its 2011 proposal, the CFTC no longer recognizes as *bona fide,* transactions used to hedge risk from storage, transmission or generation of commodities. The EEMAC learned that these transactions form the "bread and butter" of energy industry efforts to hedge risks—and thereby pass along the best possible prices to consumers.[12] Although the CFTC once recognized the legitimacy of this sort of hedge, the new proposal denies *bona fide* hedge treatment, apparently because of the fear of abuse in the agricultural sector where a storage bin could be used for multiple commodities [13]—soybeans and corn, for example. Yet, the proposed rule does not explain why this transaction is unavailable in the energy space, where storage, transmission and generation are obviously not fungible in the same way.[14] I recently toured the Valero refinery in Houston. I did not need to have a degree in chemical engineering to understand that liquefied natural gas or generated electricity cannot be stored in a gasoline tank farm. The CFTC rules need to recognize that as well.

2. Merchandising and Anticipatory Hedging

EEMAC members expressed considerable frustration that the CFTC's proposal does not recognize the importance of merchandising and its role in connecting the two ends of the value chain: production and consumption.[15] Moreover, merchandising promotes market convergence, an important component of price discovery and market health.[16] EEMAC members explained that unfixed price contracts are frequently used in merchandising transactions and argued forcefully that the CFTC should re-evaluate its approach to basis contracts.

3. Cross-Commodity Hedges

EEMAC members also raised significant concerns with the CFTC's application of the hedge exemption to cross-commodity hedges. Cross-commodity hedging, such as hedging jet fuel with ultra-low sulfur diesel futures contracts, is currently permitted in the spot month and is critical to the price-discovery process, but would not be permitted under the position-limits proposal.[17] Similarly, EEMAC members stated that the proposed quantitative restriction on cross-commodity hedges was deeply problematic.[18] This proposed quantitative restriction would kill long-used, tried-and-true cross-commodity hedges, including hedging electricity with natural gas and fuel oil with crude oil.[19]

4. Gross *versus* Net Hedging

Finally, EEMAC members raised concerns regarding the CFTC's proposed approach of permitting hedging only on an enterprise-wide level. The EEMAC heard evidence that this approach substitutes regulatory edict for the common-sense business judgments that underlie existing risk-management procedures and hedging programs.[20] The risk-management systems and procedures on which so many hedgers depend were built in reliance on long-standing CFTC interpretations, which this proposal changes suddenly and with questionable justification.[21] In some cases, the CFTC's proposed approach is in tension with other state or Federal regulatory requirements with regard to hedging or reliability.[22]

I am very concerned that the effect of the CFTC's proposed exclusion of these common exemptions and its narrowed list of remaining exemptions is to impose a Federal regulatory edict in place of business judgment in the course of risk-hedging activity by America's commercial enterprises. The CFTC is primarily a markets regulator, not a prudential regulator. It has neither the authority nor the technical expertise to substitute its regulatory dictates for the commercial judgment of Amer-

[12] *Id.* at 170–76.
[13] *Id.* at 174–75.
[14] *E.g., id.* at 178–79.
[15] *E.g., id.* at 161–62, 190–91, 209.
[16] *E.g., id.* at 191.
[17] *E.g., id.* at 115–16.
[18] *E.g., id.* at 191, 200–03; see also Proposal, 78 FR at 75717–18 (describing quantitative factor and suggesting it should preclude electricity-natural gas cross commodity hedging).
[19] EEMAC Tr. at 200–203.
[20] *E.g., id.* at 158–60, 186–87, 216–18.
[21] *See id.*
[22] *Id.* at 216–18.

ica's business owners and hedgers when it comes to basic risk management. Instead, the CFTC must allow for greater flexibility and encourage commercial enterprises to adapt to developments and advances in hedging practices, not impede their efforts to do so.

In short, I share Rep. Neugebauer's concerns. In my view, the Commission and the staff have to think carefully about many aspects of the proposed *bona fide* hedge exemption. The CFTC needs to take special care that in chasing excessive speculation, it does not needlessly add unnecessary burdens on hedgers, end-users and consumers—the very participants that Congress intended to protect against excessive speculation.

I pledge to work closely with my fellow Commissioners, the CFTC staff, and Members of Congress, particularly on this Committee, to ensure that the CFTC's position limits rule preserves the ability of America's commercial enterprises to prudently manage their risks without needless constraint or added cost.

Hon. J. CHRISTOPHER GIANCARLO, *Commissioner,* U.S. Commodity Futures Trading Commission

Response from Hon. Mark P. Wetjen, Commissioner, Commodity Futures Trading Commission

Question Submitted by Hon. Randy Neugebauer, a Representative in Congress from Texas

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Answer. For decades prior to the Dodd-Frank Act, the Commodity Exchange Act did not provide a definition for *bona fide hedge* positions. Instead, the Commission created a definition of and process for granting hedge exemptions in rule 1.3(z) of the Commission's regulations. Under the Dodd-Frank Act, Congress directed the Commission to define what constitutes a *bona fide* hedge or position, subject to certain enumerated criteria. The Commission's proposed rule provided that *bona fide* hedge positions do not count towards speculative position limits and provided a list of enumerated *bona fide* hedging positions. The Commission also provided a process to seek relief from the Commission for risk-reducing practices a person commonly uses in the market that are not included in the enumerated list.

The proposed rule also explicitly requested comment in a number of areas. For instance, comments were requested on industry practices involving the hedging of risks of cash market activities in a physical commodity that were not enumerated in the list of *bona fide* hedge positions; on all aspects of transactions or positions proposed that were not included in the enumerated list; and on the appropriate measures to consider an anticipated merchandising transaction as a *bona fide* hedging position. In addition, the Commission asked for comment on whether it should adopt an administrative procedure that would allow the Commission to more easily add additional enumerated *bona fide* hedges.

Recognizing the importance of getting the *bona fide hedging* definition right, last year as acting Chairman, I directed the CFTC staff to hold a public roundtable in order to provide another opportunity for the Commission to hear from commercial end-users on how they use derivatives to hedge their risks. The roundtable was helpful and informative, and separately generated more than 50 comment letters addressing *bona fide* hedging and other important aspects of the CFTC's proposed position limits rule. The Commission has now received hundreds of comments on the subject of Federal position limits and *bona fide* hedge positions, including comments in response to the requests in the proposal and from the recent meeting of the Energy and Environmental Markets Advisory Committee. The Commission and its staff are still considering the comments we have received, including those from the

commercial end-users, farmers, ranchers, and other participants who use our markets to hedge risk. In finalizing a rule for *bona fide* hedge positions and exemptions, we should ensure that we provide the appropriate flexibility, including the flexibility to hedge legitimate anticipated business needs. We should also ensure that there is an efficient process for granting additional *bona fide* hedge exemptions where appropriate going forward.

I look forward to continuing to work with Chairman Massad, my fellow Commissioners, and staff on this issue.